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Audits of property and liability insurance companies with conforming changes as of May 1, 2002; Audit and accounting guide:

American Institute of Certified Public Accountants. Insurance Companies Committee

AICPA Audit and Accounting Guide

Audits of Property and Liability Insurance Companies

With Conforming Changes as of May 1, 2002

American Institute of Certified Public Accountants

AICPA

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Guide

AUDITS OF PROPERTY AND LIABILITY INSURANCE COMPANIES

With Conforming Changes as of May 1, 2002

This edition of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*, which was originally issued in 1990, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page iv). The changes made in the current year are identified in a schedule in appendix Z of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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NOTICE TO READERS

This audit and accounting guide presents recommendations of the AICPA Property and Liability Insurance Companies Task Force on the application of generally accepted auditing standards to audits of financial statements of property and liability insurance entities. This guide also presents the Task Force's recommendations on and descriptions of financial accounting and reporting principles and practices for property and liability insurance companies.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two thirds of the members of the accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the Financial Accounting Standards Board. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.

This Guide contains significant discussions of statutory accounting practices that includes laws, regulations, and administrative rulings adopted by the various states that govern the operations and reporting requirements of life insurance entities. Because this is a category b document as described above, the inclusion of descriptions of statutory accounting practices does not elevate statutory accounting practices into generally accepted accounting principles.

Auditing guidance included in an AICPA Audit and Accounting Guide is an *Interpretive Publication* pursuant to SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Interpretive Publications are recommendations on the application of Statements on Auditing Standards (SASs) in specific circumstances, including engagements for entities in specialized industries. Interpretive Publications are issued under the authority of the Auditing Standards Board. The members of the Auditing Standards Board have found this guide to be consistent with existing Statements on Auditing Standards.

The auditor should be aware of and consider Interpretive Publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable Interpretive Publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

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This edition of the Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the guide was originally issued. This guide reflects relevant guidance contained in authoritative pronouncements through May 1, 2002:

FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*

FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensationan Interpretation of APB Opinion No. 25*

FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*

EITF consensuses adopted through the January 2002 Emerging Issues Task Force (EITF) meeting

Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes*

SAS No. 96, *Audit Documentation*

SOP 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*

SSAE No. 11, *Attest Documentation*

The changes made during the most recent update are identified in a schedule in appendix Z of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

This publication includes information from the following: Practice Bulletin (PB) 15, *Accounting by the Issuer of Surplus Notes,* Statement of Position (SOP) *Auditing Property and Liability Reinsurance,* SOP 92-4, *Auditing Insurance Entities' Loss Reserves,* SOP 92-3, *Accounting for Foreclosed Assets,* SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance,* SOP 92-8, *Auditing Property/Casualty Insurance Entities' Statutory Financial Statements Applying Certain Requirements of the NAIC Annual Statement Instructions,* SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises,* SOP 94-1, *Inquiries of State Insurance Regulators,* SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises,* SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises,* SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments,* SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association,* SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk,* and SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification.* Recent pronouncements, including SOP 01-5, have amended some of the aforementioned original literature that has been included in this publication for easy reference.

Preface

This audit and accounting guide, which supersedes the 1966 AICPA Industry Audit Guide, *Audits of Fire and Casualty Insurance Companies* and the statements of position (SOPs) that amend that guide (except for the SOP *Auditing Property and Liability Reinsurance* which has been incorporated into chapter 6 of this guide), has been prepared to assist the independent auditor in auditing and reporting on financial statements of property and liability insurance companies. This guide describes operating conditions and auditing procedures unique to the industry and illustrates the form and content of financial statements and disclosures for property and liability insurance companies, various pools, syndicates, and other organizations such as public entity risk pools. Chapter 1 discusses the nature, conduct, and regulation of the insurance industry. Among the other significant areas discussed in this guide are—

- Audit considerations, including a discussion of the assessment of control risk.
- The premium cycle, including a discussion of rating, transactions, accounting practices, and special risk considerations.
- The claims cycle, including a discussion of accounting practices and special risk considerations.
- The investment cycle, including a discussion of regulation, various investment alternatives, accounting practices, and special risk considerations.
- Reinsurance, including a discussion of the kinds of reinsurance, accounting practices, ceded reinsurance, and assumed reinsurance.
- Taxes, including both federal and state.
- Differences between statutory accounting practices (SAP) and generally accepted accounting principles.

In addition, appendix B discusses control activities and auditing objectives and procedures.

The specialized generally accepted accounting principles to be followed by property and liability insurance companies are included in the Financial Accounting Standards Board (FASB) *Current Text* at section In6. Discussions of accounting in this guide are generally intended to refer to authoritative literature. Discussions of statutory accounting practices are mentioned if they differ from generally accepted accounting principles. Some significant differences between generally accepted accounting principles and statutory accounting practices are discussed also in chapter 1.

Public entity risk pools are required to follow the accounting and financial reporting requirements of Governmental Accounting Standards Board (GASB) Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended and interpreted by various GASB pronouncements.* That Statement is based primarily on FASB Statement No. 60,

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* The Governmental Accounting Standards Board (GASB) has issued GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments.* That Statement fundamentally changes the format and content of financial statements for all state and local governmental entities, including public entity risk pools, and becomes effective in three phases depending on an entity's total annual revenues (as specifically defined) in the first fiscal year ending after June 15, 1999. The first implementation phase is for financial statements for periods beginning after June 15, 2001, the second implementation phase is for financial statements for periods beginning after June 15, 2002, and the third implementation phase is for financial statements for periods beginning after June 15, 2003. For all phases, earlier application is encouraged. Special transition provisions apply for component units.

Accounting and Reporting by Insurance Enterprises, and related pronouncements but includes certain accounting and financial reporting requirements that differ from FASB Statement No. 60. As discussed in chapter 1, many public entity risk pools are not subject to the same regulation as property and liability insurance companies.

The National Association of Insurance Commissioners (NAIC) continually monitors statutory accounting practices for insurance companies. Through various committees, such as the NAIC Working Group on Emerging Issues, it makes recommendations to state insurance departments regarding changes in statutory accounting and reporting. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in an *Accounting Practices and Procedures Manual effective January 1, 2001* (the revised Manual). The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC revised Manual except as prescribed or permitted by state law. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. States may adopt the revised Manual in whole or in part as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence.

As issues are resolved, amendments to this guide may be issued by the AICPA, or pronouncements may be issued by the FASB or GASB.

Effective Date

The auditing provisions of this guide are effective for audits of financial statements of property and liability insurance companies for periods beginning on or after December 15, 1990.

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Chapter 1

Nature, Conduct, and Regulation of the Business

General Nature of the Business

1.01 The primary purpose of the property and liability insurance business is the spreading of risks. The term *risk* generally has two meanings in insurance. It can mean either a *peril insured against* (for example, fire is a risk to which most property is exposed) or a *person or property protected* (for example, a home or an automobile). For a payment known as a premium, insurance companies undertake to relieve the policyholder of all or part of a risk and to spread the total cost of similar risks among large groups of policyholders.

1.02 The functions of the property and liability insurance business include marketing, underwriting (that is, determining the acceptability of risks and the amounts of the premiums), billing and collecting premiums, investing and managing assets, investigating and settling claims made under policies, and paying expenses associated with these functions.

1.03 In conducting its business, an insurance company accumulates a significant amount of investable assets. In addition to funds raised as equity and funds retained as undistributed earnings, funds accumulate from premiums collected in advance; from sums held for the payment of claims in the process of investigation, adjustment, or litigation; and from sums held for payment of future claims settlement expenses. The accumulation of these funds, their investment, and the generation of investment income are major activities of insurance companies.

Kinds of Insurance

1.04 Kinds of insurance, generally referred to as lines of insurance, represent the perils that are insured by property and liability insurance companies. Some of the more important lines of insurance are—

- *Fire and allied lines*, which include coverage for fire, windstorm, hail, and water damage (but not floods).
- *Ocean marine*, which includes coverage for ships and their equipment, cargos, freight or money to be paid for use of the ships, and liability to third parties for damages.
- *Inland marine*, which covers property being transported other than transocean. (It also includes floaters, which are policies that cover movable property, such as a tourist's personal property.)
- *Workers' compensation*, which compensates employees for injuries or illness sustained in the course of their employment.
- *Automobile*, which covers personal injury or automobile damage sustained by the insured and liability to third parties for losses caused by the insured.
- *Multiple peril*, which is a package coverage including most property and liability coverage except workers' compensation, automobile insurance, and surety bonds.

- *Professional liability*, which covers physicians, surgeons, dentists, hospitals, engineers, architects, accountants, attorneys, and other professionals from liability arising from error or misconduct in providing or failing to provide professional service.
- *Miscellaneous liability*, which covers most other physical and property damages not included under workers' compensation, automobile liability, and multiple peril policies. (Damages include death, cost of care, and loss of services resulting from bodily injury, as well as loss of use of property.)
- *Fidelity bonds*, which cover employers against dishonest acts by employees. Blanket fidelity bonds cover groups of employees.
- *Surety bonds*, which provide for monetary compensation to third parties for failure by the insured to perform specifically covered acts within a stated period. (Most surety bonds are issued for persons doing contract construction, persons connected with court actions, and persons seeking licenses and permits.)
- *Accident and health*, which covers loss by sickness or accidental bodily injury. (It also includes forms of insurance that provide lump-sum or periodic payments in the event of loss by sickness or accident, such as disability income insurance and accidental death and dismemberment insurance.)

1.05 In addition to these lines, insurance is provided by excess and surplus lines. *Excess liability* covers the insured against loss in excess of a stated amount, but only for losses as covered and defined in an underlying policy. The underlying amount is usually insured by another policy but can be retained by the insured. *Surplus lines* include coverage for risks that do not fit normal underwriting patterns, risks that are not commensurate with standard rates, or risks that will not be written by standard carriers because of general market conditions. These kinds of policies are generally written by carriers not licensed in the jurisdiction where the risk is located and generally are not subject to regulations governing premium rates or policy language.

1.06 The lines and premium volume that may be written by a company are generally restricted by state insurance regulations. States also monitor the amount of premium written as a ratio of the company's surplus.

1.07 Insurance written by property and liability insurance companies may be broadly classified as *personal lines*, which consist of insurance policies issued to individuals, and *commercial lines*, which consist of policies issued to business enterprises. Personal lines generally consist of large numbers of relatively standard policies with relatively small premiums per policy. Examples are homeowner's and individual automobile policies. Commercial lines involve policies with relatively large premiums that are often retroactively adjusted based on claims experience. The initial premium is often only an estimate because it may be related to payroll or other variables. Examples are workers' compensation and general liability. Many large insurance companies have separate accounting, underwriting, and claim-processing procedures for these two categories.

1.08 Insurance is generally available to the individual as a means of protection against loss. There are instances, however, in which a person cannot obtain insurance in the voluntary insurance market. States have established programs to provide insurance to those with high risks who otherwise would be excluded from obtaining coverage. Following are some of the more common programs that provide the necessary coverage:

- *Involuntary automobile insurance.* States have a variety of methods for apportioning involuntary automobile insurance. The most widely used approach is the Automobile Insurance Plan (formerly called the Assigned Risk Plan). Under this plan, all companies writing automobile insurance in a state are allocated a share of the involuntary business on an equitable basis. Each automobile insurer operating in the state accepts a share of the undesirable drivers, based on the percent of the state's total auto insurance that it writes. For example, a company that writes 5 percent of the voluntary business in a state may be assigned 5 percent of the involuntary applicants. It is then responsible for collecting the premiums and paying the claims on the policies issued to these applicants. Other states use a reinsurance plan, under which each insurer accepts all applicants but may place high-risk drivers in a reinsurance pool, with premiums paid to and losses absorbed by the pool. Still another approach is a joint underwriting association, in which one or more servicing companies are designated to handle high-risk drivers. All insurers in the state may be required to participate in the underwriting results.
- *FAIR plans.* FAIR (Fair Access to Insurance Requirements) plans are state-supervised programs established to provide coverage for property in high-risk areas. Companies that operate in the state are required to participate in the premiums, losses, expenses, and other operations of the FAIR plan.
- *Medical malpractice pools.* These pools were established when health-care professionals and institutions were experiencing difficulty in obtaining liability insurance in the voluntary insurance market. The pools were established by law and currently exist in the majority of states. All insurers writing related liability insurance in such states are considered mandatory participants in the pools as a condition for their continuing authority to transact business in such states.
- *Workers' compensation pools.* These pools are similar to FAIR plans. As with FAIR plans, companies operating in a given state are assessed a proportionate share, based on direct writings, of the underwriting results of the pool.

Organizations

1.09 The principal kinds of property and liability insurance organizations are—

a. *Stock companies*, which are corporations organized for profit with ownership and control of operations vested in the stockholders. Generally, the stockholders are not liable in case of bankruptcy or impairment of capital.

b. *Mutual companies*, which are organizations in which the ownership and control of operations are vested in the policyholders. On the expiration of their policies, policyholders lose their rights and interests in the company. Many states require the net assets of a mutual insurance company in liquidation to be distributed among the current policyholders of the company, and the prior policyholders have no claim against the assets. Most major mutual companies issue nonassessable policies as provided under state laws; if a mutual company is not qualified to issue such policies, however, each policyholder is liable for an assessment equal to at least one annual premium in the event of bankruptcy or impairment of minimum equity requirements. Many mutual insurance entities are seeking enhanced financial flexibility and access to capital to support long-term growth and other strategic initiatives. Because of many economic and regulatory factors, as well as increased competition, there has been a recent trend for mutual insurance companies to demutualize or to form mutual insurance holding companies. The AICPA issued SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts.* Practitioners should refer to that statement for guidance about accounting for demutualizations and the formations of mutual insurance holding companies.

c. *Reciprocal or interinsurance exchanges,* which are composed of a group of persons, firms, or corporations, commonly termed subscribers, who exchange contracts of insurance through the medium of an attorney-in-fact. Each subscriber executes an identical agreement empowering the attorney-in-fact to assume, on the subscriber's behalf, an underwriting liability on policies covering the risks of the other subscribers. The subscriber assumes no liability as an underwriter on policies covering his or her own risk; the subscriber's liability is several and not joint and is limited by the terms of the subscriber's agreement. Customarily, the attorney-in-fact is paid a percentage of premium income, from which he or she pays most operating expenses, but some exchanges pay his or her own operating expenses and compensate the attorney-in-fact at a lower percentage of premiums or by some other method.

d. *Public entity risk pools,* which are cooperative groups of governmental entities joining together to finance exposures, liabilities, or risks. Risk may include property and liability, workers' compensation, employee health care, and so forth. A pool may be a stand-alone entity or be included as part of a larger governmental entity that acts as the pool's sponsor. Stand-alone pools are sometimes organized or sponsored by municipal leagues, school associations, or other kinds of associations of governmental entities. A stand-alone pool is frequently operated by a board that has as its membership one member from each participating government. It typically has no publicly elected officials or power to tax. Public entity risk pools should be distinguished from private pools, which are organized under the Risk Retention Act of 1986. These private pools, or risk retention groups, can provide only liability coverage, whereas public entity risk pools organized under individual state statutes can provide several kinds of coverage. The four basic kinds of public entity risk pools are—

- *Risk-sharing* pools, arrangements by which governments pool risks and funds and share in the cost of losses.
- *Insurance-purchasing* pools, arrangements by which governments pool funds or resources to purchase commercial insurance products. These arrangements are also called *risk-purchasing groups.*
- *Banking* pools, arrangements by which money is made available for pool members in the event of loss on a loan basis.

- *Claims-servicing* or *account* pools, arrangements by which pools manage separate accounts for each pool member from which the losses of that member are paid.

A pool can serve one or several of those functions. Pools that act *only* as banking or claims-servicing pools do not represent transfer of risk. Such pools are not insurers and should not report as insurer.

e. *Private pools.* Because of the unavailability and unaffordability of commercial liability insurance, Congress enacted the Risk Retention Act of 1986. This Act allows the organization of private pools for the purpose of obtaining general liability insurance coverage. Two basic types of private pools are allowed:

- Risk retention groups—an insurance company formed by the members of the private pool primarily to provide commercial liability insurance to the members.
- Purchasing groups—members of a private pool purchase commercial liability insurance on a group basis.

Methods of Producing Business

1.10 The marketing department of an insurance company is responsible for sales promotion, supervision of the agency or sales force, and sales training. Property and liability insurance companies may produce business through a network of agents (agency companies) or through an employee sales force (direct writing companies), or they may acquire business through insurance brokers or through direct solicitation. A combination of methods may also be used. The distinctions among an agent, a broker, and a salesperson are based on their relationships with the insurance company.

1.11 *Agents.* Insurance agents act as independent contractors who represent one insurance company (exclusive agents) or more than one company (independent agents) with express authority to act for the company in dealing with insureds.

1.12 General agents have exclusive territories in which to produce business. They agree to promote the company's interest, pay their own expenses, maintain a satisfactory agency force, and secure subagents. They may perform a significant portion of the underwriting. They may also perform other services in connection with the issuance of policies and the adjustment of claims, including negotiating reinsurance on behalf of the insurer, which neither local agents nor brokers are authorized or expected to do.

1.13 Local and regional agents are authorized to underwrite and issue policies but are not usually given exclusive territories. They usually report either to company branch offices or directly to the company's home offices. Agents are generally compensated by commissions based on percentages of the premiums they produce. Because of their greater authority and duties, general agents usually receive higher percentages than local or regional agents.

1.14 Agents have the power to bind the company, which means that the insurance is effective immediately, regardless of whether money is received or a policy is issued. Generally, agents are considered to have vested rights in the renewal of policies sold for insurance companies. The company cannot, however, compel independent agents to renew policies, and the agents may place renewals with other companies.

1.15 *Brokers.* Insurance brokers represent only the insureds; they have no contractual relationships with insurance companies. As a result, brokers do not have the power to bind the company. Brokers solicit business and submit it for acceptance or rejection with one or more insurance companies. Brokers may submit business directly to a company or through general or local agents or through other brokers. Brokers are compensated by commissions paid by insurance companies, normally percentages of the premiums on policies placed with the companies.

1.16 *Direct writing.* Direct writing companies sell policies directly to the public, usually through salespeople, thus bypassing agents and brokers. Direct writing may be done from the company's home office or through branch sales offices. Underwriting and policy issuance may also be done from the home office or branches. The salespeople may be paid commissions, straight salaries, or a commission incentive with a base salary. Salespeople generally have the power to bind the company; however, the company retains the right to cancel the policy, generally for up to sixty days.

1.17 Direct response advertising or mass marketing is also used for producing business. This results in sales to many people simultaneously, with single programs to insure a number of people or businesses. Such methods use direct billing techniques that may also permit individuals to pay premiums by salary deductions, credit cards or as a direct draft against a checking account.

Major Transaction Cycles

Underwriting of Risks

1.18 Underwriting includes evaluating the acceptability of the risk, determining the premium, and evaluating the company's capacity to assume the entire risk.

1.19 *Evaluating risks.* Evaluating risks and their acceptance or rejection involves (*a*) a review of exposure and potential loss based on both the review of dailies (office copies of policies) and the endorsements to existing policies and (*b*) an investigation of risks in accordance with procedures established by company policy and state statutes. For example, applicants for automobile insurance may be checked by reference to reports on driving records issued by a state department of motor vehicles. Application for certain kinds of coverage may require an engineering survey, a fire hazard survey, or similar investigations. In addition, a company's underwriting policy may establish certain predetermined criteria for accepting risks. Such criteria often specify the lines of insurance that will be written as well as prohibited exposures, the amount of coverage to be permitted on various kinds of exposure, the areas of the country in which each line will be written, and similar restrictions.

1.20 *Setting premium rates.* Establishing prices for insurance coverage is known as the rate-making process, and the resultant rates that are applied to some measure of exposure (for example, payroll or number of cars) are referred to as *premiums*. Determining premiums is one of the most difficult tasks in the insurance business. The total amount of claims is not known at the time the insurance policies are issued and, for many liability policies, is not known until years later. Determining proper premium rates is further complicated by the fact that no two insurable risks are exactly alike. The intensity of competition among hundreds of property and liability insurance companies in the United States is also significant in setting premiums.

1.21 Premium rates may be established by one of three methods:

a. *Manual rating*, which results in standard rates for large groups of similar risks, used, for example, in many personal lines such as automobile insurance

b. *Judgment rating*, which depends on the skill and experience of the rate-maker, used generally for large or unusual risks such as ocean marine insurance

c. *Merit rating*, which begins with an assumed standard or "manual" rate that is adjusted based on an evaluation of the risk or the insured's experience in past or current periods, used in many commercial lines such as workers' compensation

1.22 The transaction cycle for premiums is described in detail in chapter 3.

1.23 *Reinsurance.* Insurance companies collect amounts from many risks subject to insurable hazards; it is expected that these amounts will be sufficient in the aggregate to pay all losses sustained by the risks in the group. To do so, the number of risks insured must be large enough for the law of averages to operate. However, insurance companies are often offered, or may be compelled to accept, insurance of a class for which they do not have enough volume in the aggregate to permit the law of averages to operate. Further, companies often write policies on risks for amounts beyond their financial capacities to absorb; or a company may write a heavy concentration of policies in one geographic area that exposes the company to catastrophes beyond its financial capabilities. Ordinarily, all or part of such risks are passed on to other insurance or reinsurance companies.

1.24 Spreading of risks among insurance companies is called *reinsurance*. The company transferring the risk is called the *ceding company*, and the company to which the risk is transferred is called the *assuming company*, or the *reinsurer*. Although a ceding company may transfer its risk to another company through reinsurance, it does not discharge its primary liability to its policyholders. The ceding company remains liable for claims under the policy; however, through reinsurance, the ceding company reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the assuming company for the reinsured portion of the loss. The ceding company is also exposed to the possibility that the reinsurer will not be able to reimburse the ceding company.

1.25 The term *portfolio reinsurance* is applied to the sale of all or a block of a company's insurance in force to another company. This kind of reinsurance is frequently used when a company wishes to withdraw from a particular line, territory, or agency. In portfolio reinsurance, the assuming company generally undertakes responsibility for servicing the policies—collecting the premiums, settling the claims, and so on—and the policyholder subsequently deals directly with the assuming company.

1.26 *Fronting.* Fronting is an arrangement between two or more insurers whereby the fronting company issues a policy and then cedes all or substantially all the risk through a reinsurance agreement to the other insurer(s) (the fronted company) in return for a ceding commission. As with other reinsurance contracts, the fronting company remains primarily liable on the insurance contract with the insureds. Fronting arrangements usually are initiated by fronted companies that are not authorized to write insurance in particular states.

1.27 The principal kinds of reinsurance agreements and the mechanics of reinsurance are discussed in detail in chapter 6.

1.28 *Pooling.* The term *pooling* is often used to describe the practice of sharing among groups of affiliated insurance companies all or portions of the insurance business of the groups. Each premium written by the affiliated companies is customarily ceded to one company; then, after allowing for any business reinsured outside the group, the premiums are in turn ceded back in agreed-upon ratios. Claims, claim adjustment expenses, commissions, and other underwriting and operating expenses are similarly apportioned. Each member of the group shares pro rata in the total business of the group, and all achieve similar underwriting results. Another kind of pooling involving sharing of risks among governmental entities is discussed in paragraph 1.09.

1.29 *Underwriting pools, associations, and syndicates.* Underwriting pools, associations, or syndicates are formed by several independent companies or groups of companies in joint ventures to underwrite specialized kinds of insurance or to write in specialized areas. These groups are often operated as separate organizations having distinctive names and their own staffs of employees. The pools, associations, or syndicates may issue individual or syndicate policies on behalf of the member companies, which share in all such policies in accordance with an agreement, or policies may be issued directly by the member companies and then reinsured among the members in accordance with the agreement. The agreement stipulates the group's manner of operation and the sharing of premiums, claims, and expenses. Such groups customarily handle all functions in connection with the specialized business that would otherwise have to be handled by specific departments in each of the member companies. This kind of arrangement usually is more economical in handling the business for the members.

1.30 *Captives.* Noninsurance businesses try to use various methods to minimize their cost of insurance. Other than retaining the risk (that is, self-insurance), perhaps the most conventional method is the use of captive insurers. Captive insurers are wholly owned subsidiaries created to provide insurance to the parent companies. Captives were originally formed because no tax deductions are allowed if risks are not transferred, whereas premiums paid to insurers are tax deductible. Many captives are chartered in locales in which the business climate is receptive to their formation. However, in 1977 the IRS ruled that premiums paid to an offshore captive would not be allowed as a deductible expense unless a significant volume of insurance was placed with the captive firm by companies outside the consolidated group. The Tax Reform Act of 1986 subjects any U.S. person who owns stock in a 25 percent or more U.S.-owned foreign insurance company to current taxation based on its pro rata share of income arising from insuring risks of U.S. shareholders and related parties.

Processing and Payment of Claims

1.31 An insurance company's claim department accepts, investigates, adjusts, and settles claims. The first step in the claims process is for the insured to notify the company that a loss has occurred. The insured reports the loss to the agent, who will either help the insured to prepare or will prepare a loss report, which will be forwarded to the insurance company. The second step is investigation and adjustment, which is designed to determine whether a loss occurred and whether the loss is covered by the policy. Companies generally use claims adjusters, who may be employees of the insurance companies or of the agents, to investigate claims. Insurance companies may also use outside organizations to adjust claims.

1.32 *Adjustment bureaus.* Insurance companies establish adjustment bureaus to investigate and settle some or all of the claims of the member companies. Subject to certain limitations, an adjustment bureau adjusts claims and negotiates the settlement of claims for each company, with each company retaining the final power of approval or disapproval. Expenses of the adjustment bureau are shared by all members on an equitable basis generally determined by the number or dollar volume of claims referred to it for adjustment.

1.33 *Independent adjusters.* Insurance companies engage independent adjusters, who charge stipulated fees for their services to investigate and adjust certain claims. The adjustment process also includes estimating the loss. The adjuster will help determine the amounts of losses and the reserves required.

1.34 The third step of the claims process is claim settlement, either payment or denial of a claim. After settlement (through negotiation or court action) with a claimant, a check or draft is issued for the amount of the adjusted claim. Upon receipt of payment, the claimant generally signs a release indicating that final settlement has been received.

1.35 The transaction cycle for claims is discussed in more detail in chapter 4.

Investments

1.36 Property and liability insurance companies function as conduits of funds. They collect funds, known as premiums, from those desiring protection from financial loss and disburse funds to those who incur such losses. Between receipt of premiums and payment of losses, which can be long periods for third-party claims, the companies invest these funds.

1.37 Because insurance companies must be able to meet the claims of their policyholders, their investments should be both financially sound and sufficiently liquid. To ensure that companies will be able to meet their obligations, statutory restrictions have been placed on their investment activities. Although statutes and regulations vary from state to state, most states specify maximum percentages of a company's assets and/or surplus that may be placed in various kinds of investments. In addition, regulatory authorities may require that some investments be deposited with the state insurance departments as a condition for writing business in those states. Investment standards and restrictions for public entity risk pools differ significantly from standards for insurance companies. In some jurisdictions, public entity risk pools must follow regulations governing the investment of public funds. Invested assets consist primarily of bonds and marketable equity securities, but investments are also commonly made in mortgage loans and income-producing real estate. In addition, the insurance industry has been increasingly utilizing options, financial futures, and other instruments in its investment activities.

1.38 Most insurance companies have separate investment departments responsible for managing the companies' investable funds. Insurers should plan investments so that the maturities of their investment portfolios match their claims payment patterns. This is generally referred to as *asset and liability management or asset/liability matching*—that is, funds are invested so that the income from these investments plus maturities will meet the ongoing cash flow needs of the company. This matching approach requires a correct mix of long-and short-term investments.

1.39 The transaction cycle for investments is discussed in more detail in chapter 5.

Accounting Practices

1.40 Although the increased use of systems application software interfaced with general ledger packages has encouraged the use of full accrual accounting records by many insurers, many companies still maintain their general ledger on a modified cash basis and then prepare financial statements for regulatory filings on an accrual basis. The accounting practices used to prepare such statutory financial statements differ in some respects from United States generally accepted accounting principles (GAAP), as discussed in chapter 8.

1.41 Under SAP, as defined in Statement of Statutory Accounting Principle (SSAP) No. 4, *Assets and Admitted Assets*, paragraph 2, "For the purposes of statutory accounting, an asset shall be defined as: probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. . . . These assets shall then be evaluated to determine whether they are admitted." Paragraph 3 of SSAP No. 4, discusses nonadmitted assets, 'As noted in the Statement of Concepts, "The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet,' and are, therefore, considered nonadmitted." A nonadmitted asset should be charged against surplus unless specifically addressed in the NAIC Accounting Practices and Procedures Manual.

State Insurance Regulation

1.42 The insurance industry is deemed to be a business vested with the public interest and is regulated by the states. Statutes in each state provide for the organization and maintenance of an insurance department responsible for supervising insurance companies and enforcing compliance with the law. Property and liability insurance companies are subject to formal regulation by the insurance department of the state in which they are domiciled and are also subject to the insurance regulations of the states in which they are licensed to do business. Although statutes vary from state to state, they have as their common principal objective the development and enforcement of measures designed to promote solvency, propriety of premium rates, fair dealings with policyholders, and uniform financial reporting.

1.43 State statutes (*a*) restrict investments of insurance companies to certain kinds of assets, (*b*) prescribe methods of valuation of securities and other assets, (*c*) require maintenance of reserves, risk-based capital, and surplus, and (*d*) define those assets not permitted to be reported as admitted assets.

1.44 The states regulate insurance premium rates to ensure that they are adequate, reasonable, and not discriminatory. In a 1944 decision, the United States Supreme Court held that insurance is interstate commerce and as such is subject to regulation by the federal government. However, in 1945 Congress passed the McCarran-Ferguson Act, which exempts the insurance business from antitrust laws. Although Congress insisted that the federal government has the right to regulate the insurance industry, it stated in the McCarran-Ferguson Act that the federal government would not regulate insurance as long as state legislation provided for the supervision of insurance companies, including rate making. The following practices are protected by the McCarran-Ferguson Act:

- Pooling of statistical data for rate making
- Standard policy forms and standardized coverage
- Joint underwriting and joint reinsurance (such as insurance pools for exceptional hazards)
- Tying of various lines of insurance, that is, making the purchase of lines of insurance that are unprofitable to the insurance company conditional on the purchase of profitable lines

1.45 All states have passed legislation requiring insurance commissioners to review, with or without prior approval, most rates charged by insurance companies. A company must file most rates with the insurance department of each state in which it is authorized to do business. A number of states also require formal or tacit approval of rates by respective state insurance departments.

1.46 To promote fair dealing with policyholders, state statutes provide for certain standard provisions to be incorporated in policies and for the insurance departments to review and approve the forms of policies. Insurance agents, brokers, and salespeople must qualify for and obtain licenses granted by the insurance department of a state before they may conduct business in the state.

1.47 To promote uniform financial reporting, as previously discussed, the statutes provide for annual or more frequent filings with the insurance departments in prescribed form.

1.48 In a majority of states, insurance companies may not be organized without the authorization of the insurance department and, in states in which such authorization is not required, approval by the insurance department is necessary for the completion of organization.

1.49 An insurance department generally consists of an insurance commissioner or superintendent in charge, one or more deputies, and staffs of examiners, attorneys, and clerical assistants. Many larger insurance departments also employ actuaries to review rate filings and to assist in the monitoring of financial solvency, principally relating to loss reserves. A commissioner usually is granted discretionary powers and can issue rules and regulations necessary to ensure compliance with state statutes.

National Association of Insurance Commissioners

1.50 To create greater uniformity both in the laws and their administration and to recommend desirable legislation in state legislatures, the state commissioners of insurance organized an association that is known today as the National Association of Insurance Commissioners (NAIC). The work of the NAIC over the years has helped to eliminate many conflicts of state law and to promote more uniform and efficient regulation of insurance companies. The NAIC meets at least four times a year in general sessions. The organization has appointed committees to consider various proposals presented that cover all phases of the insurance business. The decisions of the NAIC are not binding on any of the commissioners, but state legislatures and insurance departments generally adopt, with some exceptions, NAIC "model statutes" or regulations.

Federal Regulation—Securities and Exchange Commission

1.51 Because property and liability insurance companies are subject to state insurance department supervision and regulations, the Securities Exchange Act of 1934 contains certain provisions exempting stock property and liability insurance companies from registration with the Securities and Exchange Commission (SEC). However, a large number of companies have registered under the 1934 Act, either in connection with the listing of their shares on a national securities exchange or because they have formed holding companies that do not qualify for exemption under the 1934 Act. Property and liability insurance companies registered under the 1934 Act must comply with the SEC's periodic reporting requirement and are subject to the proxy solicitation and insider-trading rules. Insurance companies making public offerings are required to file under the Securities Act of 1933 and must thereafter comply with the annual and periodic reporting requirements of the 1934 Act. However, these companies are not under the proxy solicitation or insider-trading rules of the Act as long as they meet the attendant provisions for exemption. Insurance companies that are SEC registrants should follow Article 7 of SEC Regulation S-X, SEC Industry Guide 6, and applicable Staff Accounting Bulletins, which prescribe the form and content of financial statements.

Industry Associations

1.52 The property and liability insurance industry has many industry associations to help with the multitude of technical problems that arise in the course of business. These organizations also monitor regulatory developments and provide public relations for the industry. (See appendix G for a list.)

Statutory Accounting Practices

1.53 State insurance departments require insurance entities to maintain records in accordance with statutory accounting practices (SAP). Statutory accounting employs those accounting principles and practices prescribed or permitted by an insurer's domiciliary insurance department and in some instances, by the insurance departments of other states in which the insurer is licensed to write business, that is, authorized to do business.

1.54 In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance entities, resulting in a revised Accounting Practices and Procedures Manual effective January 1, 2001 (the "revised Manual"). The insurance laws and regulations of most states require insurers to comply with the guidance provided in the revised Manual except as prescribed or permitted by state law. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence.

1.55 The Preamble of the revised Manual notes the following as the statutory hierarchy, which is not intended to preempt state legislative regulatory authority:

Level 1:

- SSAPs including GAAP reference material categories a, b and c from the GAAP hierarchy

- Category a includes: FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins
- Category b includes: FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position
- Category c includes: Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins.

Level 2:

- Consensus positions of the Emerging Accounting Issues Working Group as adopted by the NAIC

Level 3:

- NAIC Annual Statement Instructions
- NAIC *Purposes and Procedures of the Securities Valuation Office* manual

Level 4:

- Statutory Accounting Principles Statement of Concepts

Level 5:

- GAAP reference material below category c in the GAAP Hierarchy

1.56 The revised Manual, the NAIC's *Annual Statement Instructions*, *Examiners Handbook*, *Valuations of Securities Manual*, committee minutes, model rules, regulations, and guidelines provide sources of SAP. Some states may issue circular letters describing their positions on various areas of accounting. In areas in which specific accounting practices are not prescribed, widely recognized practices may be permitted in a given state or specific accounting applications may be approved by the state insurance department, either orally or in writing. Auditors are able to review state examiners' reports to obtain evidence of accounting practices that have either been explicitly or implicitly accepted on examination.

1.57 Each state insurance department requires all insurance entities licensed to write business in that state to file an *Annual Statement*, also referred to as the convention blank, statutory blank, or simply the blank, with the state insurance commissioner for each individual insurance entity. Most states require the blank to be filed by March 1 of the following year. All states require that the *Annual Statement* for the calendar year be comparative, presenting the amounts as of December 31 of the current year and the amounts as of the immediately preceding December 31. The *Annual Statement* includes numerous supplementary financial data, such as Analysis of Operations by Lines of Business and detailed schedules of investments. The NAIC's *Instructions to the Annual Statement* require that insurance entities file in conjunction with their *Annual Statement* (1) an opinion by a qualified actuary concerning the adequacy of reserves and other actuarial items and that such reserves conform with statutory requirements and (2) a narrative document captioned "Management Discussion and Analysis" discussing material changes in significant annual statement line items and material future operating events, similar to the disclosures currently required by the SEC for public companies. The Management Discussion and Analysis is due April 1 of the following year.

1.58 The NAIC requires most insurance entities in all states to file, by June 1, an Audited Financial Report with the insurance commissioners of their state of domicile and all other states in which they are licensed. Exemptions to requirements to file include insurance entities that write less than one million dollars in direct premiums. The financial statements included in the Audited Financial Report should be prepared in a form and using language and groupings substantially the same as the relevant sections of the *Annual Statement* of the insurer. The annual Audited Financial Report is to include a reconciliation of differences, if any, between the audited statutory financial statements contained in that report and the *Annual Statement* filed with the state commissioner and a written description of the nature of the differences.

1.59 Insurers are required to have their auditors prepare and file an "Accountants' Letter of Qualification" and a "Report on Significant Deficiencies in Internal Controls" in accordance with the NAIC instructions. Some states also require the filing of an "Evaluation of Accounting Procedures and System of Internal Control" letter.

1.60 Many public entity risk pools are not required to prepare reports on a SAP basis. Enabling legislation generally sets forth each pool's reporting requirements and may require pools to report to the state insurance commissioner or state agency. Separate rules may apply to reporting, capitalization requirements, and so forth.

1.61 Insurance companies are examined regularly by state or zone (a group of states) insurance examiners, usually once every three to five years. The Annual Statements filed with the regulatory authorities are used to monitor the financial condition of insurance companies in the period between examinations and to provide the financial data to help regulate the industry.

1.62 In addition to the audits of financial statements, insurance examiners review compliance with laws or regulations concerning policy forms, premium rates, kinds of investments, composition of the board of directors, members' attendance at board meetings, reinsurance contracts, intercompany transactions, and fair treatment of policyholders. Insurance examiners use the *Examiners Handbook*, a publication of the NAIC that outlines the procedures for conducting an examination as a guide in performing examinations and in preparing reports. Many of the steps followed in the examination are similar to those followed by independent auditors.

1.63 Insurance entities prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile, that is, SAP. SAP are considered an other comprehensive basis of accounting (OCBOA) as described in Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623).

1.64 Prescribed statutory accounting practices are practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.

Permitted Statutory Accounting Practices

1.65 Permitted SAP include practices not prescribed in paragraph 1.53 but allowed by the domiciliary state regulatory authority. An insurance entity may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of its statutory financial statements if either of the following occur:

a. The entity wishes to depart from the prescribed SAP.

b. The prescribed SAP do not address the accounting for the transaction specifically.

Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

1.66 The disclosures in this paragraph should be made if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices. The disclosures should be made if the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed. If an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1]

1.67 Financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describe how that basis differs from GAAP. As noted in the Preamble of the revised Manual, paragraph 55, "To the extent that disclosures required by a SSAP are made within specific notes, schedules, or exhibits to the annual statement, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by annual statement exhibits and schedules (e.g., annual audit report) shall include all disclosures required by the SSAPs based on the applicability, materiality and significance of the item to the insurer. Certain disclosures, as noted in individual SSAPs, are required in the annual audited statutory financial statements only." Exhibit 1.1, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," provides guidance in evaluating whether informative disclosures are reasonably adequate for financial statements prepared on a statutory basis, and has been modified as a result of the completion of the NAIC codification.

Generally Accepted Accounting Principles

1.68 In 1966, the AICPA issued the Industry Audit Guide *Audits of Fire and Casualty Insurance Companies*, which included guidance on prescribed

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[1] Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. GAAP financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority, and their monetary effects.

financial reporting principles and practices. In response to variations in accounting practices, and in an effort to clarify and expand the accounting discussion in the guide, in 1978 the AICPA issued Statement of Position (SOP) No. 78-6, *Accounting for Property and Liability Insurance Companies*. Then, in 1982, the Financial Accounting Standards Board issued FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, which sets forth specialized industry accounting principles for insurance companies. Other FASB pronouncements which significantly affect insurance companies include FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Investments*, FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement Nos. 137 and 138 and EITF Abstract No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*. Other accounting principles pertaining specifically to property and liability insurance companies include the AICPA's SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, as amended, SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*, SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*, and SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*.

1.69 FASB Statement No. 60 classifies insurance contracts as short-duration or long-duration contracts. The classification depends on whether a contract is expected to provide coverage for an extended period. The factors that should be considered in determining whether a particular contract can be expected to remain in force for an extended period are—

a. A *short-duration contract*, which provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

b. A *long-duration contract*, which generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and which requires the performance of various functions and services (including insurance protection) for an extended period.

Determining whether a contract is short-duration or long-duration requires both judgment and an analysis of the contract terms. Most property and liability insurance contracts currently issued are classified as short-duration contracts.

1.70 Under FASB Statement No. 60, premiums from short-duration contracts ordinarily are recognized as revenue over the contract period in proportion to the amount of insurance provided, and liabilities from unpaid claims and for claim adjustment expenses are accrued when insured events occur during the contract period. Certain costs, called *acquisition costs*, vary with and are primarily related to the acquisition of insurance contracts. These costs are capitalized and charged to expense in proportion to premium revenue recognized (that is, also over the contract period). (Particular sections of this audit guide discuss the requirements of FASB Statement No. 60, but the reader should refer to the statement itself for specific guidance.)

1.71 GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended and interpreted by various GASB pronouncements,* sets forth the accounting and financial reporting requirements for public entity risk pools. GASB Statement No. 10, as amended and interpreted, is based primarily on FASB Statement No. 60 but includes certain accounting and financial reporting requirements that differ from FASB Statement No. 60. In addition to the requirements of GASB Statement No. 10, there are other pronouncements of the GASB that affect accounting and financial reporting by public entity risk pools. For example, GASB Statement No. 3, *Deposits With Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*, requires pools to make certain disclosures about the credit and market risks of their investments. Further, GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, requires pools to present a statement of cash flows using cash flows categories that differ from those required by FASB Statement No. 95, *Statement of Cash Flows*. This guide does not attempt to highlight the areas in which different accounting or reporting is required for public entity risk pools.

SAP to GAAP Reconciliation

1.72 The differences between SAP and GAAP result from their differing emphasis, as noted in the Preamble of the revised Manual, paragraph 10, "GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. As a result, GAAP stresses measurement of emerging earnings of a business from period to period, . . . while SAP stresses measurement of the ability to pay claims in the future." Adequate statutory surplus provides protection to policyholders and permits a company to expand its premium writing. Accordingly, SAP places a great deal of emphasis on the adequacy of statutory surplus. Table 1.1, "Summary of Statutory Accounting Practices and Generally Accepted Accounting Principles," presents a summarized comparison of the major differences in accounting treatment between GAAP and SAP for selected financial statement components. The reader should, however, refer to the actual pronouncements for explicit guidance in accounting for transactions in each of the areas.

* The Governmental Accounting Standards Board (GASB) has issued GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. That Statement fundamentally changes the format and content of financial statements for all state and local governmental entities, including public entity risk pools, and becomes effective in three phases depending on an entity's total annual revenues (as specifically defined) in the first fiscal year ending after June 15, 1999. The first implementation phase is for financial statements for periods beginning after June 15, 2001, the second implementation phase is for financial statements for periods beginning after June 15, 2002, and the third implementation phase is for financial statements for periods beginning after June 15, 2003. For all phases, earlier application is encouraged. Special transition provisions apply for component units.

Table 1.1

Summary of Statutory Accounting Practices and Generally Accepted Accounting Principles

The following are highlights of significant differences in accounting treatment among pre-codification and codified statutory accounting practices (SAP) and generally accepted accounting principles (GAAP) for certain financial statement components. As described in paragraph 1.65, statutory accounting may vary by state.

Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Bonds	NAIC category 1 to 2 at amortized cost; NAIC category 3 to 6 at stipulated value.	Debt securities should be carried at amortized cost, except for those with a NAIC designation of 3 to 6, which shall be reported at the lower of amortized cost or fair value. See SSAP No. 26.	Classified as trading securities or securities available for sale at fair value; classified as held-to-maturity at amortized cost, if positive intent and ability to hold to maturity exist.
Common stock	Fair value.	Common stock is generally reported at the fair value published in the Valuations of Securities Manual, which is the determination of "market" for each listed stock by the NAIC's Securities Valuation Office. See SSAP No. 30.	Fair value.

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Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Nonredeemable preferred stock	Same as bonds, except that a P is placed in front for perpetual preferred and a PSF for mandatory sinking fund preferred stock.	Preferred stock that are of highest or high quality (designation 1 or 2) and have characteristics of equity securities, shall be valued at cost. All other preferred stocks (with designations 4 to 6) shall be reported at the lower of cost, amortized cost or fair value. See SSAP No. 32.	Fair value.
Mortgages	Unpaid balance unless in default.	First mortgages that are not in default with regard to principal or interest are carried at outstanding principal balance, or amortized cost if acquired at a discount or premium. See SSAP No. 37.	Unpaid balance plus unamortized loan origination fees as prescribed by FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases," less impairment as per FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan, as amended by FASB Statement No. 118, Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, and FASB Statement No. 5, *Accounting for Contingencies.*

(continued)

Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Real estate —Investment	Lower of depreciated cost or market.	Properties occupied by the company and properties held for the production of income are reported at depreciated cost. See SSAP No. 40.	Depreciated cost, after impairment write-down as per FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, if applicable.
—Held for sale	Lower of depreciated cost or market.	Report at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property.	Lower of carrying value or fair value less cost to sell.
Investment in affiliates	Not consolidated—NAIC value.	Investments in subsidiary, controlled or affiliated (SCA) entities should be reported using either a market valuation approach or equity methods. See SSAP No 46.*	Consolidated, equity basis, or cost as appropriate.
Unrealized gains (losses) for securities	Recorded directly to surplus.	Recorded directly to surplus.	Recorded in net income or other comprehensive income, as appropriate (except for held-to-maturity).

(continued)

* Issue Paper No. 118, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46*, has been exposed for comment. Issue Paper No. 118 clarifies when either the statutory or GAAP equity basis should be used. If adopted as a SSAP, companies may need to change the valuation basis of their noninsurance and foreign insurance subsidiaries. Readers should be alert to any final pronouncement.

Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Impairment issues (for marketable debt and equity securities)	Permitted to the extent not provided in the AVR.	For debt securities, an impairment that is considered other than temporary shall be recorded as a realized loss, and should result in the cost basis of the security being written down to the fair value as a new cost basis. For equity securities, for any decline in the fair value of common or preferred stocks that is deemed other than temporary, the equity security shall be written down to fair value as the new cost basis. The amount of the write down should be accounted for as a realized loss.	Write-down for impairment of value that is other than temporary, as described in FASB Statement Nos. 5, 114, and 115.
Nonadmitted assets	Excluded from the balance sheet and charged to surplus.	Excluded from the balance sheet and charged to surplus. See SSAP Nos. 4 and 29.	Not applicable.
Loss Reserves	—	Claims, losses and loss/claim adjustment expenses shall be recognized as expense when an event occurs. Liabilities shall be established for any unpaid expenses, with a corresponding charge to income. See SSAP Nos. 55, 62, and 65.	Accrued when insured events occur and based on the estimated ultimate cost of settling the claims. Estimated recoveries are deducted from the liability for unpaid claims.

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Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Premium Balances Receivable	Premiums recorded as assets.	For all property casualty contracts other than workers compensation, written premium is reported as the contractual amount charged to the contract holder for the effective period of the contract. For workers compensation contracts, written premium may be recorded on an installment basis to match the billing to the policyholder. See SSAP No. 53.	Premiums recorded as assets.
Contract holder dividend liability	Provision made for dividends payable on next contract anniversary.	Dividends to policyholders immediately become liabilities when they are declared and shall be recorded as a liability. See SSAP No. 65.	If limitations exist on the amount of net income from participating insurance contracts of insurers that may be distributed to stockholders, provision is made for accumulated earnings expected to be paid to contract holders, including pro rata portion of dividends incurred to valuation date; If there are no net income restrictions, the future dividends are accrued over the premium-paying period of the contract. Accounting varies depending on the applicability of FASB Statement No. 60 paragraphs 41 through 43, *Accounting and Reporting by Insurance Enterprises*.

(continued)

Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Reinsurance	Full credit generally given for authorized reinsurers; net reporting required; reinsurance recognized based on adequate transfer of risk; liability for unauthorized reinsurers.	Full credit generally given for authorized reinsurers; net reporting required; reinsurance recognized based on adequate transfer of risk; liability for unauthorized reinsurers. See SSAP No. 62.	Reinsurance recognized based on adequate transfer of risk; provision for uncollectible reinsurance and gross reporting required under FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, net reporting is not allowed unless a right of offset exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.
Deferred taxes	Not provided.	Balance sheet should include deferred income tax assets (DTAs) and liabilities (DTLs), the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109. . . Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus). Admissibility test to determine how much DTAs should be admitted. See SSAP No. 10.	Provision made for temporary differences, net operating losses, and credit carryforwards under FASB Statement No. 109, *Accounting for Income Taxes*.

(continued)

Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Liability for postretirement benefits other than pensions	Initial liability, based on vested benefits, may be amortized over twenty years.	An employer shall account for its postretirement benefits for vested employees only, on an accrual basis. SSAP No. 14 adopted FASB Statement Nos. 106 and 132 with some modifications.	Expected postretirement benefit obligations are recognized over the working life of employees; liability based on vested and nonvested benefits under FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. FASB Statement No. 132, *Employer's Disclosures about Pensions and Other Postretirement Benefits*, supersedes the disclosure requirements of FASB Statement No. 106.
Pension benefits	Usually based on ERISA funding requirements (application of FASB Statement No. 87, *Employers' Accounting for Pensions*, is optional).	For defined benefit plans, reporting entities should adopt FASB Statement No. 87, with a modification to exclude nonvested employees. For defined contribution plans, the reporting entity should expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting shall be treated as prepaid expenses and shall be nonadmitted. Contributions required after participants terminate or retire shall be accrued and an expense shall be recorded over the working lives of the participants. SSAP No. 8 adopts FASB Statement Nos. 87, 88, and 132 with some modifications.	Pension costs calculated based on the projected unit credit method under FASB Statement No. 87 FASB Statement No. 132, *Employer's Disclosures about Pensions and Other Postretirement Benefits*, supersedes the disclosure requirements of FASB Statement No. 87.

(continued)

Area	*Pre-codification Statutory Accounting Practices*	*Codified Statutory Accounting Practices*	*Generally Accepted Accounting Principles*
Contract acquisition costs	Charged to expense when incurred.	Charged to expense when incurred.	Deferred and amortized (with interest) in relation to the revenue generated (premiums or estimated gross profit, as appropriate) if recoverable from such revenue.
Consolidation	Generally not applied.	Generally not applied.	Generally required in accordance with FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

Exhibit 1.1

Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis*

Question. Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a "statutory basis") in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). Effective January 1, 2001, most states are expected to adopt a comprehensively updated *Accounting Practices and Procedures Manual*, as revised by the National Association of Insurance Commissioners' (NAIC's) Codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised Manual. The revised Manual contains extensive disclosure requirements. As a result, after a state adopts the revised Manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC Annual Statement Instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised Manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?**

Interpretation. Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to AU section 623, *Special Reports* (paragraph .04). AU section 623.09 states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as those applied to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04.

AU section 623.02 states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

Question. What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

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* Reprinted from Special Reports: Auditing Interpretations of AU Sec. 623 (AICPA, *Professional Standards*, vol. 1, AU sec. 9623).

** It is possible for one of three different situations to occur: The state adopted the revised Manual without significant departures, adopted the revised Manual with significant departures, or has not yet adopted the revised Manual.

Interpretation. AU section 623.09 and .10 indicates that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. AU section 623.10 also states that when "the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate."

Question. How does the auditor evaluate whether "similar informative disclosures" are appropriate for—

a. Items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?

b. Items and transactions that are accounted for differently under a statutory basis than under GAAP?

c. Items and transactions that are accounted for differently under requirements of the state of domicile than under the revised Manual?

Interpretation. Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under the statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP unless the revised Manual specifically states the NAIC Codification rejected the GAAP disclosures. Disclosures should also include those required by the revised Manual.

Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under the statutory basis than under GAAP, but in accordance with the revised Manual, should be the disclosures required by the revised Manual.

If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made.

When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties. Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

Question. There may also be instances in which state requirements have not been revised to reflect a new GAAP disclosure requirement. What are the disclosure requirements in those situations?

Interpretation. Until state requirements are determined, the statutory basis financial statements should include disclosures required by new GAAP requirements that are relevant and significant to the statutory basis of accounting, pending acceptance or rejection for inclusion in the revised Manual.

Chapter 2
Audit Considerations

Preliminary Audit Considerations

Overall Risk Factors

2.01 An initial step in any audit is to obtain knowledge of the entity's business and the industry in which it operates. Chapter 1 discusses the nature of the property and liability insurance business and many characteristics of operations in the industry. The Bibliography at the end of this guide provides sources for additional information on the industry. In planning an audit, the auditor should be aware of the various economic, financial, and organizational conditions that create business risks faced by companies in the industry. SAS No. 47,* *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor's consideration of the risk that the financial statements are materially misstated by error or fraud. SAS No. 82,** *Consideration of Fraud in a Financial Statement Audit*, provides specific guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud. SAS No. 54, *Illegal Acts by Clients*, prescribes the nature and extent of the consideration an auditor should give to the possibility of illegal acts by a client in an audit of financial statements. This knowledge helps the auditor judge the audit risks that may be involved in the engagement. Although conditions will vary from company to company, the independent auditor may consider the conditions discussed in the Audit Risk Alert, *Insurance Industry Developments*, for the current year.

2.02 The profitability of an insurance company on a statutory basis is generally gauged by its combined ratio and its operating ratio. The combined ratio is the sum of its loss ratio (total incurred losses and loss adjustment expenses expressed as a percent of earned premiums), its expense ratio (total underwriting expenses incurred to written premiums), and its dividend ratio (policyholder dividends expressed as a percent of earned premiums). The operating ratio is the combined ratio less the ratio of investment income to earned premiums.

2.03 The auditor should consider using the combined and operating ratios—both for the industry and for the insurance company whose financial

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* Statement on Auditing Standards (SAS) No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU secs. 312, 329, 339, and 341), among other matters, amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, to add a requirement to SAS No. 47 to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. This chapter of the Guide will be modified in a future edition of the Guide to reflect the requirements and terminology used in SAS No. 96.

** The AICPA has issued an exposure draft of a proposed SAS titled *Consideration of Fraud in a Financial Statement Audit*. This proposed SAS would supersede SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and amend SAS No. 1, section 230, *Due Professional Care in the Performance of Work*. A final standard is expected to be issued during the fourth quarter of 2002. Readers should be alert to any final pronouncement.

statements are being audited—in evaluating the audit risk at the financial statement level. For example, these ratios may provide information about the company's profitability relative to the industry and about the economic conditions prevalent in the industry as a whole.

NAIC Insurance Regulatory Information System

2.04 Many insurance laws and regulations address insurance companies' financial solvency, and insurance departments consequently monitor reports, operating procedures, investment practices, and other activities of insurance companies. One of the main purposes of the monitoring system is to detect, at an early stage, companies that are insolvent or may become insolvent.

2.05 To assist state insurance departments in monitoring the financial condition of property and liability insurance companies, the NAIC Insurance Regulatory Information System (IRIS) was developed by a committee of state insurance department regulators. It is intended to assist state insurance departments in identifying insurance companies requiring close surveillance. The system is based on twelve tests for property and liability insurance companies. The tests are based on studies of financially troubled companies compared to financially sound companies. Usual ranges have been established under each of the tests for a property and liability company, but the ranges may be adjusted to reflect changing economic conditions. The results of the tests of all companies are compared, and those companies with three or more results outside of the usual range are given a priority classification indicating that a close review of the company should be undertaken. In addition, a regulatory team annually reviews the results and recommends regulatory attention if needed. One or more results outside the usual range does not necessarily indicate that a company is in unstable financial condition, but the company may need to explain the circumstances causing the unusual results. Annually, the NAIC publishes a booklet entitled *NAIC Financial Solvency Tools—Insurance Regulatory Information System (IRIS)*, which explains the IRIS ratios in detail. (Each of the individual ratios and the acceptable results is briefly described in appendix E.) IRIS test results may be useful in analytical procedures performed in the planning stage of an audit.

2.06 The NAIC has also established risk-based capital standards for the property and liability insurance industry. Risk-based capital provides minimum means of setting the capital standards for insurance companies to support their overall business operations in light of their size and risk profile. A company's risk-based capital is calculated by applying factors to various asset, premium, and reserve items, where the factor is higher for those items with greater underlying risk and lower for less risky items. Risk-based capital standards will be used by regulators to set in motion appropriate regulatory actions relating to insurers which show signs of weak or deteriorating conditions. They also provide an additional standard for minimum, below which companies would be placed in conservatorship.

NAIC Profitability Reports

2.07 The annual statement and supplemental exhibits are the sources of data for the NAIC Profitability Reports. The Overall Profitability Report develops six rates of return: two on sales (earned premium), two on net worth, and two on assets. The Overall Profitability Report by Company was developed by the NAIC in 1971. The stated purpose of the report is to establish uniform standards for measuring the profitability of property-liability insurance companies (individually and for companies collectively) on a basis that will facilitate comparisons with other businesses and industries. Certain assumptions are made, and the data reported in insurers' annual statements are adjusted by formulas adopted by the NAIC to estimate a "going-concern" basis. Annually, the NAIC publishes a booklet entitled *Using the NAIC Profitability Results*. This booklet explains in detail the rate-of-return calculations for the Overall Profitability Report by company. In addition to the NAIC, several states have developed their own systems of early-warning tests.

2.08 Other industry sources useful in the preliminary assessment of audit risks include annual and quarterly statements filed with regulatory authorities, regulatory examination reports, IRS examination reports, and communications with regulatory authorities.

Specific Audit Risk Factors

2.09 Experience has demonstrated that audit risk may be greater in certain operating areas than in others. The most significant transaction cycles of property and liability insurance companies are the premium cycle, the claims cycle, and the investment cycle. Risk factors specific to these cycles, as well as other audit risk factors, are described in appendix A to this guide. Although the summary of the risk potential in these operating areas is not all-inclusive, the summary does present major areas of recommended concentration in determining the nature and extent of audit procedures described in other chapters of this guide. The auditor's preliminary conclusions regarding the degree of audit risk may be modified by the results of audit work performed. The procedures described throughout this guide for each major operating cycle focus on the preceding overall risks as well as on other kinds of audit risks, and the auditor should refer to those chapters for additional guidance.

Internal Control

2.10 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the objectives and components of internal control and explains how an independent auditor should consider internal control in planning and performing an audit. In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT) and manual procedures may affect controls relevant to the audit. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor then assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The AICPA Audit Guide *Consideration of Internal Control in a Financial Statement Audit* provides further guidance on the application of SAS No. 55 in audits of financial statements performed in accordance with generally accepted auditing standards.

2.11 Internal control is a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations. Internal control consists of the following five interrelated components:[1]

a. Control environment

b. Risk assessment

c. Control activities

d. Information and communication

e. Monitoring

2.12 The auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether the controls have been placed in operation.

2.13 After obtaining an understanding of the components of internal control, the independent auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at a maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control) if the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating the effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level. For example, the auditor may determine that performing only substantive tests would be effective and more efficient than performing tests of controls for assertions related to fixed assets and to long-term debt in an entity where a limited number of transactions are related to those financial statement components, and when the auditor can readily obtain corroborating evidence in the form of documents and confirmations. In circumstances where the auditor is performing only substantive tests in restricting detection risk to an acceptable level and where the information used by the auditor to perform such substantive tests is produced by the entity's information system, the auditor should obtain evidence about the accuracy and completeness of the information.

2.14 In other circumstances, the auditor may determine that assessing control risk below the maximum level for certain assertions would be effective and more efficient than performing only substantive tests. In addition, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation of controls to support the assessed level of control risk.[2]

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[1] Paragraph 9 of SAS 55 as amended, (AICPA, *Professional Standards*, Vol. 1, AU sec. 319.09) provides that "although an entity's internal control addresses objectives in each of the categories referred to in paragraph 6, not all of these and related controls are relevant to an audit of the entity's financial statements."

[2] If the auditor is unable to obtain such evidential matter, he or she should consider the guidance in SAS No. 31, Evidential Matter (AICPA, *Professional Standards*, vol. 1, AU 326.14 and 326.25), as amended by SAS No. 80, *Amendment to SAS No. 31.*

2.15 In determining whether assessing control risk at the maximum level or at a lower level would be an effective approach for specific assertions, the auditor should consider—

- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion.
- The nature of the available evidential matter, including audit evidence that is available only in electronic form.

2.16 In circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported, the auditor may determine that it is not possible to design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated. For such assertions, significant audit evidence may be available only in electronic form. In such cases, its competence and sufficiency as evidential matter usually depend on the effectiveness of controls over its accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk.

2.17 Appendix A of the Audit Guide *Consideration of Internal Control in a Financial Statement Audit*, as amended, further describes the relationship of the auditor's consideration of internal control to other audit judgments and procedures.*

Information Processing

2.18 Because of large volumes of premium transactions and the need to maintain accountability for individual policies, most property and liability insurance companies use information technology (IT) systems to maintain statistical and accounting records. Typically, policy and agent master files are maintained on computerized systems, and companies may use telecommunications, including direct access capability by agents and insureds, integrated premium and claims data bases, and processing systems that lack traditional audit trails. Many companies have made significant investments in computer hardware and software and require large staffs of programmers, systems analysts, and technicians to maintain day-to-day operations. Dependence on IT systems and controls may affect control risk, particularly for larger multiple-line insurance companies.

2.19 As stated in SAS No. 55, as amended, an entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. The use of IT also affects the fundamental manner in which transactions are initiated, recorded, processed, and reported.

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* The Auditing Standards Board (ASB) issued during the first half of 2002 a new Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*. The Guide includes illustrative control objectives as well as three new interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

In a manual system, an entity uses manual procedures and records in paper format. Controls in such a system also are manual and may include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively, an entity may have information systems that use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace such paper documents as applications, claims payment authorizations, underwriting reviews and approvals, and related accounting records. Controls in systems that use IT consist of a combination of automated controls and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT. Insurance companies have been leading users of advanced IT methods. Consequently, the control issues involving IT have received considerable attention within the industry. The auditor should consider performing tests of controls over the general IT controls relevant to major classes of transactions within those cycles. Such general controls may include—

- *Organization and operations controls.*
  - — IT department and user department functions should be segregated.
  - — Guidelines for the general authorization of executing transactions should be provided. For example, the IT department should be prohibited from initiating or authorizing transactions.
  - — Functions within the IT department should be segregated.
- *Systems development and documentation controls.*
  - — The procedures for system design, including the acquisition of software packages, should require active participation by representatives of the users and, as appropriate, the accounting department and internal auditors.
  - — Each system should have written specifications that are reviewed and approved by an appropriate level of management and applicable user departments.
  - — System testing should be a joint effort of users and IT personnel and should include both the manual and computerized phases of the system.
  - — Final approval should be obtained prior to placing a new system into operation.
  - — All master file and transaction file conversion should be controlled to prevent unauthorized changes and to provide accurate and complete results.
  - — After a new system has been placed in operation, all program changes should be approved before implementation to determine whether they have been authorized, tested, and documented.
  - — Management should require documentation and establish formal procedures to define the system at appropriate levels of detail.
- *Hardware and systems software controls.*
  - — The control features inherent in the computer hardware, operating system, and other supporting software should be used to the maximum possible extent to provide control over operations and to detect and report hardware malfunctions.
  - — Systems software should be subjected to the same control activities as those applied to installation of and changes to application programs.

- *Access controls.*
  - — Access to program documentation should be limited to those persons who require it in the performance of their duties.
  - — Access to data files and programs should be limited to those individuals authorized to process or maintain particular systems.
  - — Access to computer hardware should be limited to authorized individuals.
- *Data and procedural controls.*
  - — A control function should be responsible for receiving all data to be processed, for ensuring that all data are recorded, for following up on errors detected during processing to ensure that the transactions are corrected and resubmitted by the proper party, and for verifying the proper distribution of output.
  - — A written manual of systems and procedures should be prepared for all computer operations and should provide for management's general or specific authorization to process transactions.
  - — Internal auditors or some other independent group within an organization should review and evaluate proposed systems at critical stages of development.
  - — On a continuing basis, internal auditors or some other independent group within an organization should review and test computer processing activities.

2.20 The sophistication of insurance IT systems is often an element of competition regarding a company's ability to service accounts. The IT operations are characterized by one or several large installations, extensive use of telecommunications equipment, including some direct-access capability by independent agents and insureds, large premium and claims data bases, some of which are integrated, and operating systems and applications that lack visible audit trails.

Audit Documentation

2.21 The auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment.

2.22 Audit documentation serves mainly to:

a. Provide the principal support for the auditor's report, including the representation regarding observance of the standards of fieldwork, which is implicit in the reference in the report to generally accepted auditing standards.[3]

b. Aid the auditor in the conduct and supervision of the audit.

2.23 Examples of audit documentation are audit programs,[4] analyses, memoranda, letters of confirmation and representation, abstracts or copies of

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[3] However, there is no intention to imply that the auditor would be precluded from supporting his or her report by other means in addition to audit documentation.

[4] See Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.05), for guidance regarding preparation of audit programs.

entity documents, and schedules or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form, or other media.

2.24 Audit documentation should be sufficient to (*a*) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained;[5] (*b*) indicate the engagement team member(s) who performed and reviewed the work; and (*c*) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

2.25 In addition to the requirements discussed in paragraphs 2.21–2.24 above, SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339),[*] provides further requirements about the content, ownership and confidentiality of audit documentation. Moreover, Appendix A to SAS No. 96 lists the audit documentation requirements contained in other statements on auditing standards.

Consideration of the Work of Internal Auditors

2.26 In audits of property and liability insurance companies, auditors may consider using the work of internal auditors in the following areas:

- Testing IT general and application controls
- Testing premiums and claims processing
- Testing the integrity of the data bases underlying the loss-reserving systems

If the independent auditor will be considering or using the work of, or receiving direct assistance from, the entity's internal auditors, he or she should follow the provisions of SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

Auditor's Consideration of State Regulatory Examinations

2.27 The auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies." (SAS No. 57, *Auditing Accounting Estimates* [AICPA, *Professional Standards*, vol. 1, AU sec. 342]) "The auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the

[5] A firm of independent auditors has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including generally accepted auditing standards, and the firm's standards of quality in conducting individual audit engagements. Review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. (Also, see SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* [AICPA, *Professional Standards*, vol. 1, AU sec. 161].)

[*] SAS No. 96 supersedes SAS No. 41, *Working Papers*, and is effective for audits of financial statements for periods beginning on or after May 15, 2002. Early application is permitted. If SAS No. 96 has not been adopted, auditors should refer to SAS No. 41 for guidance. Additionally, the SAS 41 terminology "working papers" will be replaced with SAS 96 terminology "audit documentation" in a future edition of this guide.

auditor." (SAS No. 54, *Illegal Acts by Clients* [AICPA, *Professional Standards*, vol. 1, AU sec. 317]) Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance enterprises to obtain competent evidential matter.

2.28 The auditor should review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor should—

- Request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.
- Read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.
- Inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

2.29 A refusal by management to allow the auditor to review communications from, or to communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion. (SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508]) A refusal by the regulator to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

Auditor's Consideration of Permitted Statutory Accounting Practices

2.30 Prescribed statutory accounting practices are those practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

2.31 Permitted statutory accounting practices include practices not prescribed by the domiciliary state, as described in paragraph 2.30 above, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practice, or (*b*) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

2.32 Auditors should exercise care in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters. For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the domiciliary state regulatory authority.

2.33 Sufficient competent evidential matter consists of any one or combination of—

- Written acknowledgment sent directly from the regulator to the auditor. (This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.)
- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.
- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances.

2.34 If the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor should qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit. (See SAS No. 58, paragraphs 40–44.)

The Auditor's Consideration of Regulatory Risk-Based Capital for Property and Liability Insurance Enterprises[6]

Introduction and Scope

2.35 Property and liability insurance enterprises operate in a highly regulated environment. The regulation of property and liability insurance enterprises is directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the property and liability insurance system. One of the primary tools used by state insurance departments for ensuring that those objectives are being achieved is risk-based capital (RBC).

2.36 This section of the Guide addresses the auditors' responsibility that arises from the RBC requirements imposed on property and liability insurance enterprises. These RBC requirements affect audits of property and liability insurance enterprises in the following three primary areas:

a. Audit planning

b. Going-concern considerations

c. Other reporting considerations

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[6] SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises*, has been conformed to apply to property and liability insurance enterprises.

Overview of Risk-Based Capital*

2.37 Regulation of property and liability insurance enterprises has historically focused on their capital. The NAIC requires property and liability insurance enterprises to disclose RBC in their statutory filings. The RBC calculation serves as a benchmark for the regulation of property and liability insurance enterprises' solvency by state insurance regulators. RBC requirements set forth dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Such formulas focus on four general types of risk:

a. The risk related to the insurer's assets (asset risk)[7]

b. The credit risk related to the collectibility of insurance recoverables and miscellaneous receivables (credit risk)

c. The risk of adverse insurance experience with respect to the insurer's liabilities and obligations including excessive premium growth (underwriting risk)

d. All other business risks (management, regulatory action, and contingencies)

The amount determined under such formulas is called the authorized control level RBC (ACL).

2.38 RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a property and liability insurance enterprise's total adjusted capital (TAC) (equal to the sum of statutory capital and surplus and such other items, if any, as the NAIC's RBC instructions[8] may provide) to the calculated ACL. The levels of regulatory action, the trigger point, and the corrective actions are summarized as follows:

Risk-Based Capital Levels and Corrective Actions

Level	*Trigger*	*Corrective Action*
Company Action Level RBC (CAL)	TAC is less than or equal to 2 x ACL, or TAC is less than or equal to 2.5 x ACL with negative trend	The property and liability insurance enterprise must submit a comprehensive plan to the insurance commissioner.
Regulatory Action Level RBC (RAL)	TAC is less than or equal to 1.5 x ACL, or unsatisfactory RBC Plan	In addition to the action above, the insurance commissioner is required to perform an examination or analysis deemed necessary and issue a *corrective order* specifying corrective actions required.

(continued)

* The NAIC Task Force is reviewing risk based capital levels. Readers should be alert to any final pronouncement.

[7] This risk also includes risk of default.

[8] The NAIC's RBC instructions may be amended by the NAIC from time to time in accordance with procedures adopted by the NAIC.

Level	*Trigger*	*Corrective Action*
Authorized Control Level RBC (ACL)	TAC is less than or equal to 1 x ACL	In addition to the actions described above, the insurance commissioner is permitted but not required to place the property and liability insurance enterprise under regulatory control.
Mandatory Control Level RBC (MCL)	TAC is less than or equal to .7 x ACL	The insurance commissioner is required to place the property and liability insurance enterprise under regulatory control.

2.39 Under the RBC requirements, the comprehensive financial plan should—

a. Identify the conditions in the insurer that contribute to the failure to meet the capital requirements.

b. Contain proposals of corrective actions that the insurer intends to take and that would be expected to result in compliance with capital requirements.

c. Provide projections of the insurer's financial results in the current year and at least the four succeeding years, both in the absence of proposed corrective actions and giving effect to the proposed corrective actions.

d. Identify the key assumptions impacting the insurer's projections and the sensitivity of the projections to the assumptions.

e. Identify the quality of, and problems associated with the insurer's business, including but not limited to its assets, anticipated business growth and associated surplus strain, extraordinary exposure to risk, mix of business, and use of reinsurance in each case, if any.

Audit Planning

2.40 The objective of an audit of a property and liability insurance enterprise's financial statements is to express an opinion on whether they present fairly, in all material respects, the enterprise's financial position, results of operations, and cash flows in conformity with GAAP. To accomplish that objective, the auditor assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. Because of the importance of RBC to property and liability insurance enterprises, RBC should be considered in assessing risk and planning the audit. The auditor should ordinarily obtain and review the client's RBC reports and should understand the RBC requirements for preparing such reports and the actual regulations associated with RBC.

Going-Concern Considerations

2.41 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1, AU sec. 341),* requires auditors to evaluate, as part of every audit, whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statement date. A significant consideration in the auditor's evaluation of a property and liability insurance enterprise's ability to continue as a going concern is whether the enterprise complies with regulatory RBC requirements.[9]

2.42 In view of the serious ramifications of noncompliance with regulatory RBC requirements for property and liability insurance enterprises (see paragraph 2.38), such failure is a condition that indicates that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Accordingly, the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of the noncompliance with regulatory RBC capital requirements or events that gave rise to the condition and assess the likelihood that such plans can be implemented. In evaluating management's plans, the auditor should consider—

a. The property and liability insurance enterprise's existing regulatory capital position.

b. Whether a comprehensive financial plan has been filed and, if so, whether it has been accepted by the regulators.

2.43 The auditor should consider the amount of any RBC capital deficiency. In general, the lower the ratio of total adjusted capital to authorized control level RBC, the greater the doubt about the enterprise's ability to continue as a going concern for a reasonable period. The auditor should, however, also assess the likelihood that the property and liability insurance enterprise's regulatory capital position will improve or deteriorate in the next twelve months.

2.44 The auditor should also consider the nature or source (asset quality, underwriting, collectibility, or other) of the deficiency. Curing deficiencies from certain sources may be more within the control of the management of the property and liability insurance enterprise than curing deficiencies from other sources.

2.45 Furthermore, the auditor should ascertain whether a comprehensive financial plan has been filed and accepted by the commissioner. If the commissioner has accepted the comprehensive financial plan, the auditor should identify those elements of the comprehensive financial plan that are particularly significant to overcoming the adverse effects of the failure to comply with regulatory RBC requirements and should identify and perform auditing procedures to obtain evidential matter about the significant elements. For example, the auditor should consider the adequacy of support regarding an enterprise's

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* SAS No. 96, *Audit Documentation,* among other matters, amends SAS No. 59 to add documentation requirements to SAS No. 59. See paragraph 5. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted.

[9] Auditors should evaluate a property and liability insurance enterprise's ability to continue as a going concern even if the enterprise meets the minimum RBC standards. There are other conditions and events that may indicate that there could be substantial doubt about a property and liability insurance enterprise's ability to continue as a going concern, such as recurring operating losses, indications of strained liquidity, concerns expressed by regulators, and indications of strained relationships with regulators. However, this SOP discusses only failure to meet RBC standards.

ability to obtain additional capital or a planned disposal of assets. When prospective financial information is particularly significant to management's plans, the auditor should request that management provide the information and should consider the adequacy of support for significant assumptions that underlie it. Further, the auditor should identify those elements of the comprehensive financial plan and conditions placed on the property and liability insurance enterprise by the commissioner that are most difficult to achieve and consider the likelihood that the property and liability insurance enterprise will not be able to implement the elements successfully.

2.46 If the commissioner has rejected the comprehensive financial plan, the auditor should consider the commissioner's reasons for rejecting it, any revisions proposed by the commissioner to render the comprehensive financial plan satisfactory, management's intentions for revising the comprehensive financial plan, and possible regulatory sanctions. If the commissioner has not yet notified the insurer whether the comprehensive financial plan has been accepted,[10] the auditor should review related communication between the commissioner and the property and liability insurance enterprise and make inquiries of both management and regulatory officials to determine the current status of the comprehensive financial plan. If the property and liability insurance enterprise has not filed a financial plan with the commissioner,[11] the auditor should make inquiries of management officials about their comprehensive financial plan and their plans for filing.

2.47 After the auditor has evaluated management's plans, the auditor should conclude whether substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time remains or is alleviated. This is often a complex judgment requiring considerable professional experience.

Substantial Doubt Remains

2.48 If the auditor concludes that substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time remains, the auditor should (*a*) consider the possible effects on the financial statements and the adequacy of the related disclosures[12] and (*b*) modify his or her report.

2.49 Additionally, SAS No. 96 amends SAS No. 59 by requiring that the auditor should document all of the following:

- *a.* The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- *b.* The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.

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[10] The RBC Requirements require the commissioner to notify the insurer whether the comprehensive financial plan is accepted or is unsatisfactory within sixty days of submission of the plan.

[11] The RBC Requirements require that a comprehensive financial plan be filed with the commissioner within forty-five days of the failure to meet RBC standards.

[12] Auditors of publicly held property and liability insurance enterprises should consider SEC Financial Reporting Release No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*, which states, "... filings containing accountants' reports that are qualified as a result of questions about the entity's continued existence must contain appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome these difficulties."

c. The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans.

d. The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.

e. The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report. If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusions as to whether to express a qualified or adverse opinion for the resultant departure form generally accepted accounting principles.

SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. If SAS No. 96 is not effective, readers should refer to the requirements of SAS No. 41.

2.50 Additionally, if the auditor concludes that substantial doubt about the property and liability insurance enterprise's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the adequacy of disclosure in the financial statements of the principal conditions or events that initially raised the substantial doubt and comply with the documentation requirements of SAS No. 96. The auditor should also follow the guidance in SAS No. 59, paragraphs 10 and 11. Furthermore, the auditor may wish to add an emphasis of matter paragraph to the auditor's report.

Chapter 3
The Premium Cycle

3.01 Insurance companies record premiums in premiums written accounts. As policy periods expire, the premiums written are earned and are recognized as revenue. The pro rata portion of premiums written allocable to unexpired policy periods represents unearned premiums, which are reflected as a liability in the balance sheet. Premiums written are also used as a basis for paying commissions to agents, calculating premium taxes, and guaranty fund assessments.[1] The following are definitions of several kinds of written premiums.

Direct premiums. Premium income less return premiums arising from policies issued by the company collecting the premiums and acting as the primary insurance carrier.

Assumed reinsurance premiums. Premium income less return premiums arising from policies issued or other contracts entered into to reinsure other insurance companies that provide the related primary coverage.

Ceded reinsurance premiums. Outgoing premiums less return premiums arising from reinsurance purchased from other insurance companies.

Return premiums. Premium refunds due to insureds, arising from endorsements (changes in coverage, term, and so on), cancellations, or audits.

3.02 Under SAP, SSAP No. 53, *Property Casualty Contracts—Premiums*, paragraph 3 notes "written premium is defined as the contractually determined amount charged by the reporting entity to the policyholder for the effective period of the contract based on the expectation of risk, policy benefits, and expenses associated with the coverage provided by the terms of the insurance contract." This definition is for all property casualty contracts other than workers compensation, and is referred to as the "Eastern method." For workers compensation contracts, the premium may vary periodically based upon changes in the activities of the insured, and written premiums may be recorded on an installment basis to match the billing to the policyholder. This is referred to as the "Western method."

Rating

3.03 Rates used by an insurance company are based on the company's experience by line of insurance or the industry loss experience compiled by advisory rating organizations, which are subject to supervision and regulation by state insurance departments. The principal rating organizations are the National Council on Compensation Insurance (NCCI) for workers' compensation insurance, the Surety Association of America for fidelity and surety insurance, and the Insurance Services Office (ISO) for all other property and liability lines of insurance.

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[1] SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*, provides guidance on accounting by insurance and other enterprises for guaranty-fund and other assessments. See appendix R of this guide. For SAP, see SSAP No. 35, *Guaranty Fund Assessments*, for guidance. SAP has rejected SOP 97-3.

3.04 States have established mechanisms to provide insurance to those with high risks who would otherwise be excluded from obtaining coverage. For property in high-risk areas, FAIR plans, which are federally approved and state supervised, provide insurance to owners. Companies that operate in a state are assessed for any underwriting loss experienced by the FAIR plan in the state.

3.05 As discussed in chapter 1, states have several methods of apportioning involuntary automobile insurance. These methods include automobile insurance plans, joint underwriting associations, and reinsurance pools or associations.

The Transaction Cycle

3.06 The premium cycle normally includes the following functions, which generate most premium-related transactions:

- Evaluating and accepting risks
- Issuing policies
- Billing and collecting premiums
- Paying commissions and other costs of acquiring business
- Adjusting premiums
- Home office and branch office recordkeeping

Evaluating and Accepting Risks

3.07 The evaluation and risk-accepting function has three general objectives: to evaluate the acceptability of the risk, to determine the premium, and to evaluate the company's capacity to retain the entire risk.

3.08 To initiate new business, an agent or broker submits to the company an application for a policy, often with a deposit from the customer for a portion of the estimated premium. Pending issuance of the policy, the agent or broker provides the insured with a binder, which is a temporary contract that may be oral or written. The period covered by the binder is usually short, often limited to thirty days or less. A written binder is evidence of an understanding by both parties of what the insurance covers, the amount of insurance, the premium charged, and the company writing the insurance. The cash is recorded in a clearing (suspense) account and deposited, and the application is forwarded to the company's underwriting department for evaluation. The risks are evaluated in accordance with company procedures; these may include a review of exposure and potential loss based on the applications, changes, or endorsements to existing policies submitted by the agent or broker. For example, applications for automobile insurance may be checked by requesting motor vehicle reports issued by a state department of motor vehicles. Applications for certain property coverages may require engineering surveys or fire hazard surveys. (Refer to appendix A for a summary of audit risk factors.)

3.09 If an application is denied, the deposit premium is returned to the applicant with an explanation. When the refund is sent, the suspense account is cleared.

3.10 If the underwriter determines that the applicant falls within the company's underwriting guidelines and is an acceptable risk, an underwriting report is prepared, and the risk is coded so that the company can prepare reports concerning premiums, such as—

- Premiums by state, by line of business, and by underwriting year, which are required to be included in the company's annual statement.
- Premiums written by territory and by class of risk, required by the company or rating bureaus to aid in ratemaking.
- Premiums by producer, required to prepare agents' production reports and to compute any contingent commissions due at the end of a year.

Proper coding of premiums is important for the above reports and because it affects areas such as loss ratios by line of business, future underwriting and pricing, treaty reinsurance, premium tax assessments, and contingent commission arrangements.

3.11 Accounting entries are made for accepted applications by crediting premiums written, clearing the premium cash-suspense account for the deposits, and recording the balances due as premiums receivable. The combination of the rating codes entered on the underwriting report becomes the basis for the premium rates charged. A portion of the premiums is deferred because the billed premiums are for coverage to be provided by the insurance company over the term of the policy. At the end of each reporting period, unearned premiums are calculated, and the change in unearned premiums is recorded as a charge or credit to premium income.

3.12 Premiums are generally established by one of three methods: class or manual rating, individual or judgment rating, or merit rating, which are defined as follows:

- *Class or manual rating* is used primarily to establish rates for various coverages for individuals, families, and small businesses. Based on statistical data, these large groups of similar risks can be classified by a few important and easily identifiable characteristics. These classifications result in standard rates.
- *Individual or judgment rating* is used when the rates for large or unusual risks are established almost entirely by the skill and experience of the rate maker, such as ocean marine risks.
- *Merit rating* is generally used for larger risks of commercial lines and is divided into three types. *Schedule rating* starts with an assumed standard, frequently the manual rate, and adjusts such standard rate according to an evaluation of greater or lesser exposure to risk. Schedule rating is often used in fire insurance or commercial properties. *Experience rating* departs from manual rates based on the insureds' past experiences under the coverage. Premiums are adjusted prospectively based on average past experience. Experience rating is widely used in workers' compensation insurance. *Retrospective experience rating* differs from experience rating in that it adjusts the premium during the period of coverage based on actual experience during that same period. Policies that are retrospectively rated often specify minimum and maximum premiums and, in effect, may leave some risks uninsured. (Paragraph 3.23 discusses retrospective premium adjustments.)

3.13 A renewal of a policy is a new contract but, unless otherwise stated, the terms are those of the original policy. The risk insured under the original policy expires when the policy expires, and each renewal must be considered as an application for a new risk. When a policy is renewed, the premium is determined in the same manner as for a new business.

3.14 Finally, after a risk has been accepted and the premium has been calculated, a determination must be made as to whether the entire risk should be retained or whether all or part of it should be reinsured. Reinsurance is discussed in detail in chapter 6.

Issuing Policies

3.15 Applications and endorsements that have been accepted are submitted, along with an underwriting report, to a coding unit for verification of items on the underwriting report. Verified applications are then coded for data entry into the statistical system. Coded applications are batched, and input control totals are established before delivery to data entry. Alternatively, many companies have the capability to submit applications on-line. After coded applications and endorsements have been entered into the system, batch control totals generated by the computer are compared to the input control totals. Processing the information generates a premium register and documents known as *declaration sets*, which include the billing statement and insurance I.D. card, as well as information such as terms of the policy, lines of coverage, premiums, and agent information. The policy, including any endorsements, is prepared, assigned a sequential policy number, and sent directly to the insured or to the agent or broker for distribution.

Billing and Collecting Premiums

3.16 The two basic methods for billing premiums are agency billing and direct billing. Some companies use only one of these methods; others use both. Under direct billing, the company bills insureds directly for premiums due and, on collection, remits commissions to the agents. The following are several variations of agency billing, also called *account current*:

- *Account current "item basis."* For individual policies, the agent collects the premiums directly from the insureds, subtracts his or her commissions, and remits the net premiums due the company. If the agent cannot collect a premium during the credit period allowed by the company, he or she may request cancellation of the policy.
- *Account current "rendering basis."* The agent submits to the insurance company a statement of all the policies issued or due during the current month, and the net amount of the statement is subsequently to be paid in accordance with the agency agreement. The statement, which includes all known current activity, such as endorsements, cancellations, or audits, is compared to the company's accounts receivable and adjusted as necessary.
- *Account current "billing basis."* The company sends the agent a statement that contains a listing of all the policies written or due, minus the policies canceled during the month. The net amount of the statement is to be paid in accordance with the agency agreements.

3.17 The credit terms to agents are usually outlined in the agency agreement. The agent's account current is usually payable within a specified period after the last day of the month of the account.

3.18 Uncollected premiums from an agent represent premiums due the company from the agent based on his or her contract with the company to write insurance, to collect the necessary premiums, and to remit the collected premiums net of commissions. Uncollected premiums from an agent are generally reflected as "Agents' Balances" or "Uncollected Premiums," which are netted against the commissions payable on the uncollected premiums. Companies should also consider FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.* Interpretation No. 39 defines *right of setoff* and specifies what conditions must be met to have that right.

3.19 Uncollected premiums from policyholders represent premiums due the company that may have been directly solicited from policyholders either by an agent or by the company. The company sends bills directly to the policyholders, and the policyholders remit the premiums directly to the company. Customers typically have the option of remitting premiums on an installment basis. Policies and billing, therefore, may be on a monthly, quarterly, or annual cycle. If an agent had solicited the business, the company, after receiving payments from the policyholders, either sends the agent a check or otherwise credits the agent's account for his or her commission. Under direct billing, the entire amount of uncollected premiums is generally recorded as "Agents' Balances or Uncollected Premiums," and the commissions on the uncollected premiums are not netted but are recorded as a liability.

3.20 The premium collection department is responsible for accounting for customer remittance advices and the agent's account current. Adequate control over these documents and the related cash must be maintained to ensure that all payments received are processed. Customer and agent remittances should be batched and input control totals established before data entry. These input control totals should be compared to output control totals generated in the EDP department. As a result of processing, the agency cash-receipts register, difference ledger, and agent's aged trial balance are generated. The related files are then updated.

3.21 The agency cash-receipts register is reconciled with the cash-receipts record. The premium register includes information by line of business, such as current premiums, commissions, year-to-date premiums, current expired, premiums in force, and earned and unearned premiums. The difference ledger results from a comparison of accounts current submitted by the agent with transactions recorded on the company's records. Old outstanding differences and large discrepancies are reviewed and investigated. Differences may occur because the agent and the company use different cutoff dates or because of errors or omissions by the agent or the company. An agent's aged trial balance includes information such as the current month's premiums, net premiums, prior balance, cash received, net balance, installment fees, and balance due. The total premium column equals total written premiums shown on the premium register. In addition, the agent's trial balance is reviewed to determine any uncollectible accounts.

Paying Commissions and Other Costs of Acquiring Business

3.22 Agents, both independent and exclusive, and brokers are compensated for their services by commissions. Some commissions are paid on the basis of a standard percentage of premiums or on an agreed scale, known as level commissions. Retroactive commissions are used in areas such as workers' compensation, in which the final premium may be experience rated and the commissions would therefore require adjustment. Contingent commissions result from agreements with agents and brokers whereby the amounts of commissions are contingent on favorable loss experience of the business placed with the company. Establishing accounting provisions for contingent commissions is difficult because they are based on estimates of the ultimate loss experience, and in many cases the commission period does not coincide with the company's fiscal year. FASB Statement No. 60, paragraph 44, discusses accounting for contingent commission arrangements. Refer to SSAP No. 66, *Retrospectively Rated Contracts*, for additional SAP guidance on accounting for contingent commissions.

Adjusting Premiums

3.23 Adjustments to premiums written and to unearned premiums can result from—

- *Cancellation*, a complete termination of an existing policy before expiration. Cancellation results in a return premium to the insured.
- *Endorsements*, changes in existing policies that may result in additional premiums or return premiums, such as increases or decreases in coverage limits, additions or deletions of property or risks covered, or changes in location or status of insureds.
- *Audit premiums*, premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. An audit may result in an additional premium or a return premium. An example of a policy subject to audit premiums is a workers' compensation policy for which the premium is based on the payroll of the employer.
- *Retrospective premium adjustments*, modifications of the premiums after expiration of the policies. An adjustment is based on the experience of an individual risk during the term of the policy and is generally subject to maximum and minimum premium limits specified in the policy.
- *Policyholder dividends*, dividends paid to policyholders either in cash or as credits against each policyholder's next renewal premium.

Home Office and Branch Office Recordkeeping

3.24 Record-processing functions performed through branch locations vary among property and liability insurance companies. Further, those functions may vary depending on whether the company is direct billing or agency billing. The use of EDP has decentralized activities through computer input-output devices for remote locations in branch and field offices. For remote entry and access, the branch office, in effect, functions as an extension of the home office's centralized data processing.

3.25 For branch operations in which processing, accounting, and recordkeeping activities are decentralized, several alternative approaches exist. The more efficient and effective methods minimize duplication and result in compatibility between the branch and home office procedures.

3.26 Companies may follow these procedures for controlling policies and applications for policies at their branch offices:

- Applications are forwarded to the home office daily, with or without control listings.
- Applications are accompanied by control listings that have been balanced to entries made in branch records.
- Applications are retained at the branch offices, and only monthly summary journal entries are transmitted to the home office for entry in the general ledger.

- Policy numbers are assigned at branch offices or the home office, and overall numerical control of policies is maintained at the home office.

3.27 Companies may follow these procedures to control cash receipts at their branch offices:

- Branch offices prepare journal entries and forward them with the cash to the home office for deposits.
- Branch offices deposit cash in their branch accounts and transmit copies of the deposit slips and statements of cash applications to the home office.
- Branch offices deposit locally, and forward only the bank receipts to the home office. Branch offices forward monthly journal entries that summarize the monthly deposits to the home office.

3.28 Home office record-maintenance methods may include—

- Duplication of branch records.
- Maintenance of detailed entries of policies for statistical purposes but only a control account for uncollected premiums.
- Use of summary controls received monthly from the branches for both premiums and cash.

Premiums Transaction Flow

3.29 The following summarizes the premiums transaction flow of an insurance company:

a. An agent or broker submits a binder or application for a policy to the insurance company, often with a deposit premium.

b. Underwriting evaluates the risk, often using predetermined acceptance criteria and other factors such as a knowledge of the agent or broker.

c. If the risk is accepted, the amount of premium is determined, and the policy is issued. Premiums are generally established by class rating, individual rating, or merit rating. If the application is denied, the deposit premium is returned to the applicant with an explanation.

d. A decision to reinsure part or all of the risk is made. If reinsurance is chosen, the reinsurance company is notified, and the amount of ceded premium is determined.

e. Premiums are billed either by agency billing using an account current with the agent or by direct billing. Written premiums are recorded as an unearned premium reserve and are recognized as revenue over the period of risk in proportion to the amount of insurance protection provided.

f. Commissions and other costs of acquiring business are paid. Certain costs, known as *deferred acquisition costs*, typically are capitalized and amortized over the term of the policy.

g. Premiums may be adjusted over the life of the policy or at the expiration of the policy. Adjustments may result from audits, endorsements, or retrospective rating.

Accounting Principles

3.30 The specialized industry accounting principles for insurance enterprises are specified in FASB Statement No. 60. The following is a brief discussion of the principles and policies relating to the premium cycle. Readers should refer to the FASB Statement for specific guidance. Most property and liability insurance contracts are classified as short-duration contracts, and this guide generally focuses on such contracts.

Revenue Recognition

3.31 Premiums from a short-duration contract ordinarily should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This generally results in premiums being recognized as revenue evenly over the contract period. Under a few kinds of contracts, the period of risk differs significantly from the contract period. An example is insurance policies for recreational vehicles issued for an annual period, covering claims that are incurred primarily in the summer months. Under other kinds of contracts, the amount of coverage declines over the contract period on a scheduled basis. In those cases, the premium is recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. Unearned premiums, that portion of the premium applicable to the unexpired period of the policy, are included as an unearned premium reserve within the company's balance sheet.

3.32 As discussed in FASB Statement No. 60, some premiums are subject to subsequent adjustment (for example, retrospectively rated or other experience-rated insurance contracts). In these cases, the premium is determined after the period of the contract and is based on claim experience, or reporting-form contracts, for which the premium is adjusted after the period of the contract based on the value of insured property. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the period of the contract. It should be revised to reflect current experience. However, if the ultimate premium cannot be reasonably estimated, the cost-recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable. Under the cost-recovery method, premiums are recognized as revenue in amounts equal to estimated claims as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until then. Under the deposit method, premiums are not recognized as revenue and claims are not charged to expense until the ultimate premium is reasonably estimable, and income recognition is postponed until that time.

3.33 Under SAP, written premiums are generally recorded on the effective date of the contract, with an unearned premium reserve established to reflect the amount of premium for the portion of insurance coverage that has not yet expired. SSAP No. 53, notes "The exposure to insurance risk for most property and casualty insurance contracts does not vary significantly during the contract period. Therefore, premiums from those types of contracts shall be recognized in the statement of income, as earned premium, using either the daily pro-rata or monthly pro-rata methods as described in paragraph 7 [of SSAP No. 53]. Certain statements provide for different methods of recognizing premium in the statement of operations for specific types of contracts." As noted in paragraph 3.02, workers compensation contracts have premiums that may vary periodically, which is why premiums are allowed to be recorded on an installment basis which is similar to the billing frequency.

Policy Acquisition Costs

3.34 Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Examples of such costs are commissions and other costs, such as salaries of certain employees involved in the underwriting and policy-issue functions, as well as premium taxes and inspection fees that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred. Acquisition costs should be capitalized and amortized by a method similar to that used for amortizing unearned premiums. The computation should be made by reasonable groupings of the company's business in a manner consistent with the company's manner of acquiring, servicing, and measuring the profitability of its insurance products. If deferred acquisition costs are based on the relationship of costs incurred to written premiums, called the *equity-in-unearned-premium* method, such relationship should be consistently applied throughout the term of the policies unless adjustments for deficiencies are required. Under SAP, acquisition costs are expensed as incurred.

Premium Deficiencies

3.35 A premium deficiency relating to short-duration insurance contracts indicates a probable loss. A premium deficiency should be recognized if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortized acquisition costs, and maintenance costs exceeds related unearned premiums. To determine if a premium deficiency exists, insurance contracts should be grouped consistently with the company's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. A premium deficiency is recognized by first charging unamortized acquisition costs to expense to the extent required to eliminate the deficiency. Disclosure is required about whether the insurance company considers anticipated investment income in determining whether a premium deficiency relating to short-duration contracts exists. If the premium deficiency is greater than unamortized acquisition costs, a liability for the excess deficiency should be accrued. Under SAP, SSAP No. 53 incorporates the same basic premise for determining a premium deficiency reserve but notes the following in paragraph 15, "Commission and other acquisition costs need not be considered in the premium deficiency analysis to the extent they have previously been expensed. For purposes of determining if a premium deficiency exists, insurance contracts shall be grouped in a manner consistent with how policies are marketed, serviced and measured. A liability shall be recognized for each grouping where a premium deficiency is indicated. Deficiencies shall not be offset by anticipated profits in other policy groupings."

Accounting for Contracts That Do Not Transfer Insurance Risk

3.36 SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. The transfer of insurance risk requires transferring both timing risk and underwriting risk. SOP 98-7 applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to as *deposit accounting*. SOP 98-7 neither addresses when deposit accounting should be applied, nor provides criteria to make that determination. Such guidance is provided on a case-by-case basis in the applicable pronouncements. (Paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, EITF Issue No. 93-6, and EITF Issue No. 93-14 provide guidance on when deposit accounting should be applied to insurance and reinsurance contracts.) The accounting by the insured and insurer are symmetrical, except as noted in paragraph 15 of SOP 98-7.

3.37 Paragraph 9 of SOP 98-7 requires that at inception, a deposit asset or liability be recognized for insurance or reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit asset and liabilities should be reported on a gross basis, unless the right of setoff exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

3.38 Paragraphs 10 through 17 of SOP 98-7 provide guidance about the measurement of the deposit asset or liability at subsequent reporting dates. The subsequent measurement of the deposits is based upon whether the insurance and reinsurance contract (1) transfers only significant timing risk, (2) transfers only significant underwriting risk, (3) transfers neither significant timing nor underwriting risk, or (4) has indeterminate risk.

3.39 Paragraphs 18 and 19 of SOP 98-7 require the following disclosures:

a. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

b. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

(1) The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses.

(2) Any adjustments of amounts initially recognized for expected recoveries. (The individual components of the adjustment [meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries] should be disclosed separately.)

(3) The amortization expense attributable to the expiration of coverage provided under the contract.

3.40 Under SAP, guidance on accounting for contracts that do not transfer risk can be found in SSAP No. 52, *Deposit-Type Contracts*, which is generally the same principles as under GAAP. Structured settlements should be recorded consistent with the accounting provided for structured settlements in SSAP No. 65, *Property and Casualty Contracts*.

Special Risk Considerations

3.41 To plan and carry out tests of transactions in the premium cycle, it is helpful for the auditor to understand the specific conditions that may increase the risks of error or fraud in the transactions and related account balances. These conditions may be peculiar to an individual company's business practices, markets, products, or risk philosophies. This section provides examples of conditions that may indicate special risks in the premium cycle and that might be considered by the auditor in the audit. The factors considered in assessing risk should be evaluated in combination in making an overall judgment; the presence of some factors in isolation would not necessarily indicate increased risk.

3.42 The following are examples of conditions that may indicate special risks in the premium cycle:

- Rapid growth in premium volume
- New lines of business
- Changes in pricing or underwriting practices
- Premium deficiencies
- Distribution of products through the Internet

3.43 In evaluating the use of anticipated investment income in calculating a premium deficiency, the auditor should consider reviewing the company's cash flow assumptions and calculations based on anticipated claim payment patterns.

3.44 The auditor must also recognize that many areas of the premium cycle, such as policy acquisition costs, loss ratios, and premium deficiencies, may be evaluated through the use of a loss reserve specialist. In these cases, the auditor should refer to chapter 4 of this guide.

Accounting by Certain Entities That Lend to or Finance the Activities of Others

3.45 SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provides accounting guidance to any entity that lends to or finances the activities of others. The summary of significant accounting policies must include the basis for accounting for trade receivables, and the classification and method of accounting for other receivables. Receivables for property and liability companies include, but are not limited to, mortgage loans, agents' balances, premiums receivable, workers' compensation deductible recoveries, reinsurance recoverables, and securities on deposit with state insurance departments (which require financial statement disclosure). SOP 01-6 requires that a description of the accounting policies and methodology the entity used to estimate its allowance for doubtful accounts be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment and may also include discussion of risk elements relevant to particular categories of financial instruments. In addition, SOP 01-6 requires that the summary of significant accounting policies include the policy for charging off uncollectible trade receivables.

3.46 The SOP, requires disclosure of the method for recognizing interest income on loans, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs. In addition, SOP 01-6 requires disclosure of a description of the accounting policies and methodology the entity used to estimate its allowance for loan losses. SOP 01-6 requires that any liability for off-balance sheet credit losses and related charges for loan or other credit losses should be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment and may also include discussion of risk elements relevant to particular categories of financial instruments.

3.47 Additionally, SOP 01-6 requires that the summary of significant accounting policies include:

- the policy for placing loans on nonaccrual status and recording payments received on nonaccrual loans, and the policy for resuming accrual of interest
- the policy for charging off uncollectible loans
- the policy for determining past due or delinquency status.

SOP 01-6 requires that the allowance for credit losses, and, as applicable, any unearned income, any unamortized premiums or discounts, and any net unamortized deferred fees and costs should be disclosed in the financial statements. In addition, SOP 01-6 requires that the recorded investment in loans on nonaccrual status as of each balance-sheet date should be disclosed in the notes to the financial statements. The recorded investment in loans past due ninety days or more and still accruing should also be disclosed. SOP 01-6 contains other presentation and disclosure requirements that may apply to the financial statements of insurance entities. Readers should refer to the full text of SOP 01-6 when evaluating lending and financing activities of property and liability insurance enterprises.

Chapter 4

The Loss Reserving and Claims Cycle

Accounting Practices

4.01 The specialized industry accounting principles for insurance enterprises are described in FASB Statement No. 60, FASB Statement No. 97, FASB Statement No. 113, and SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance*, SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, as amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*, SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, and SOP 00-3, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*.

4.02 Under GAAP, liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. The liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors. Estimated recoveries on unpaid claims, such as salvage and subrogation are deducted from the liability for unpaid claims. A liability for those adjustment expenses expected to be incurred in the settlement of unpaid claims should be accrued when the related liability for unpaid claims is accrued. Changes in estimates of the liabilities resulting from their periodic review and differences between estimates and ultimate payments are reflected in the income of the period in which the estimates are changed or the claim is settled. If the liabilities for unpaid claims and claim-adjustment expenses are discounted (that is, the liabilities are not recorded at their ultimate cost because the time value of the money is taken into consideration), the amount of the liabilities presented at present value in the financial statements and the range of interest rates used to discount those liabilities are required to be disclosed. For public companies, the SEC staff issued Staff Accounting Bulletin No. 62, *Discounting by Property/Casualty Insurance Companies*, which discusses the appropriate accounting and financial reporting when a company adopts or changes its policy with respect to discounting certain unpaid claims liabilities related to short-duration insurance contracts. The SEC issued Financial Reporting Release No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, which requires additional disclosures concerning the underwriting and claims reserving experience of property-casualty underwriters. The SEC staff also issued Staff Accounting Bulletin No. 87, *Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs*, which provides guidance concerning those uncertainties surrounding property and casualty loss reserves that may require FASB Statement No. 5 contingency disclosures and Staff Accounting Bulletin No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, which provides the SEC staff's interpretation of current accounting literature relating to the following:

- Offsetting of probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties
- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liability, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Statutory Accounting Practices

4.03 Under SAP, as noted in SSAP No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*, paragraph 4, "Claims, losses, and loss/claim adjustment expenses shall be recognized as expense when a covered or insured event occurs. . . . Claim payments and related expense payments are made subsequent to the occurrence of a covered or insured event and, in order to recognize the expense of a covered or insured event that has occurred, it is necessary to establish a liability. Liabilities shall be established for any unpaid claims and unpaid losses (loss reserves), unpaid loss/claim adjustment expenses (loss/claim adjustment expense reserve) and incurred costs, with a corresponding charge to income." Additional SAP guidance can be found in SSAP No. 62, *Property and Casualty Reinsurance*, and SSAP No. 65, *Property and Casualty Contracts*. Statutory accounting practices (SAP), which vary by state, are similar to GAAP for transactions in the claims cycle—estimated liabilities for unpaid claims, including IBNR and claim-adjustment expenses, are accrued when the insured events occur; however, there are certain differences. Under SAP, reinsurance recoverable on unpaid losses is deducted from the liability for unpaid claims.

4.04 As noted in SSAP No. 65, paragraph 10, "With the exception of fixed and reasonably determinable payments such as those emanating from workers' compensation tabular indemnity reserves and long-term disability claims, property and casualty loss reserves shall not be discounted." The financial statements should disclose if the liabilities for unpaid losses or unpaid loss adjustment expenses are discounted, see SSAP No. 65 paragraphs 14 and 15 for required disclosures.

4.05 For SAP, reinsurance recoverable balances are segregated between those recoverable from companies authorized by the state to transact reinsurance and those recoverable from other companies, called unauthorized reinsurers. Under statutory accounting practices, when reinsurance is placed with an unauthorized company, which is therefore not subject to its jurisdiction and regulation, the ceding company must maintain and report a liability account (or accounts) for reserve credits taken and the losses recoverable that have been recorded to the extent it has not retained funds or obtained letters of credit.

Types of Business and Their Effect on the Estimation Process

4.06 The reporting and payment characteristics of a company's losses will differ depending on the types of policies written. Insurance policies may be categorized in several different ways:

- By policy duration (short-duration or long-duration)
- By type of coverage provided (occurrence basis or claims-made basis)
- By kind of insurance underwritten—in this chapter, the terms *line of business* and *type of risk* are used interchangeably to mean kind of insurance underwritten (for example, property, liability, workers' compensation, and reinsurance)[1]

Policy Duration

4.07 Insurance policies are considered to be either short-duration or long-duration. Policies are considered short-duration when the contract provides for insurance coverage for a fixed period of short duration and enables the insurer to cancel the contract or adjust the provisions of the contract at the end of the contract period. Policies are considered long-duration when the contract provides for insurance coverage for an extended period and is not generally subject to unilateral changes in its provisions. Because most policies written by property and liability insurance companies are short-duration policies, only short-duration contracts are considered in this chapter.

Type of Coverage

4.08 Insurance policies may be issued on either an occurrence basis or a claims-made basis. Occurrence-basis policies provide coverage for insured events occurring during the contract period, regardless of the length of time that passes before the insurance company is notified of the claim. Under occurrence-basis policies, claims may be filed months or years after the policy contract has expired, making it difficult to estimate the eventual number of claims that will be reported. Theoretically, a pure claims-made policy only covers claims reported to the insurer during the contract period; however, in practice, claims-made policies generally cover claims reported to either the insurer or the insured during the contract period. As a result, claims may be reported to the insurer after the contract expires. Even if claims have been reported to the insurer during the contract period, it may take several months for the insurer to investigate and establish a case reserve for reported claims. In practice, most claims-made insurance policies contain "extended reporting" clauses or endorsements that provide for coverage, in specified circumstances, of claims occurring during the contract period but reported after the expiration of the policy. In many states, a claims-made insurance policy is required to (*a*) contain an extended-reporting clause, (*b*) provide for the purchase, at the policyholder's option, of "tail coverage," that is, coverage for events occurring during the policy term but reported after the initial policy expires, or (*c*) provide for automatic tail coverage upon the death, disability, or retirement of the insured. Thus, in practice, claims-made policies can resemble occurrence-basis policies. If a claims-made insurance policy provides for coverage of claims incurred during the policy period but reported to the insurer after the end of the policy period, loss reserve requirements for such claims should be considered.

Kind of Insurance Underwritten, Line of Business, or Type of Risk

4.09 The kind of insurance underwritten by property and liability insurance companies may be broadly categorized into five classes of coverage: property, liability, workers' compensation, surety, and fidelity. Additionally, policies may be written as primary coverage or reinsurance assumed.

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[1] The terms *line of business* and *type of risk* are used interchangeably to mean kind of insurance underwritten.

4.10 Claims can be further classified as primary or reinsurance. Primary coverage involves policies written between an insurer and a customer directly. Reinsurance coverage involves the transfer of the insurer's risk to a reinsurer (see chapter 6). Retrocession (sometimes also called reinsurance) involves the further transfer of the reinsurer's risk to a retrocessionaire (sometimes also called a "reinsurer"). Excess claims are those in which another insurer or the insured pays a significant portion of the claim amount (called a retention) before the excess coverage responds. Retentions can be thousands of dollars or millions of dollars, depending on the situation.

4.11 Property claims generally are reported and settled quickly, often within several months. Some exceptions to this general rule are coverages known as business interruption insurance and ocean marine insurance. Property claims usually are first-party claims, that is, they are direct obligations of the insurer to pay the insured, with the claimant being the policyholder. In addition, the occurrence and the extent of property losses are relatively easily determinable because the claims relate to tangible property. The processing of property claims is often streamlined through bulk reserving or small-claim procedures in which many small claims are summarized and aggregated.

4.12 Liability claims are reported more slowly than property claims, and settlement is often delayed, especially if litigation is involved. Liability claims are third-party claims in which the insurer has agreed to pay, defend, or settle claims made by third parties against the insured. A single insured event may result in several claimants. In processing a liability claim, many companies keep a single file for each insured event, with separate identification of each claimant.

4.13 Workers' compensation claims are reported quickly, and some claims are settled slowly. The amount of most claim payments is set by law and may change during the life of a claim. A claim settlement is characterized by numerous payments to the claimants or survivors for medical expenses and loss of earnings, possibly over extended periods of time.

4.14 In some instances, surety or fidelity claims may be reported and settled very slowly because the loss may be discovered months or years after it has occurred. Determining the extent of the loss also often takes a long time. Financial guarantee insurance has become a significant insured risk to some companies. Financial guarantees include the guaranteeing of interest and principal payments on corporate and municipal debt, the guaranteeing of limited partnership obligations, and a number of other products in which the insurance company takes on an obligation to pay at some later date. The ultimate exposure to a large loss can be high with financial guarantees.

4.15 Some lines of insurance are commonly referred to as "long-tail" lines because of the extended time required before claims are ultimately settled. Examples of long-tail lines are automobile bodily injury liability, workers' compensation, professional liability, and other lines such as products and umbrella. Lines of insurance in which claims are settled relatively quickly are called "short-tail" lines. It is generally more difficult to estimate loss reserves for long-tail lines because of the long period that elapses between the occurrence of a claim and its final disposition, and the difficulty of estimating the settlement value of the claim.

The Transaction Cycle

4.16 Although specific procedures vary from company to company, there is a common pattern to the flow of transactions through the claims cycle, which consists of the following major functions: claim acceptance and processing, claim adjustment and estimation, claim settlement, and loss reserve evaluation.

Claim Acceptance and Processing

4.17 Notice of a loss or accident is received at the home or branch office directly from the insured or through agents. A file number for the claim, which forms the basis for all future references, is assigned to the case, usually in numerical sequence, and a loss file and abstract are prepared. Policy applications or other records of insurance coverage are examined to determine whether the loss is covered by the insurance policy and whether the policy was in force at the time the loss occurred. Questions of coverage are usually raised when the case is new. Failure to raise questions promptly may be prejudicial to a company's rights. If it appears that the claim is covered, the case is assigned to an adjuster. Some companies establish a diary file instead of a claim file when a notice of an incident is received and the company is not certain that the facts require them to establish a claim file and record an estimate. For example, an insured under a liability policy may report an injury but the injury is not expected to result in a claim. The diary file items may be referred to as precautionary claims in the context of excess claims.

4.18 Claim file face sheets containing abstracts of coverage and loss notices are prepared along with information for later use in the development of statistics used for reserve analysis and product pricing. In addition to the line of business classification, claims are classified by state, location of risk, date of loss, and policy year. Coding of claims data is important because errors in coding data directly affect the reliability of information used to report historical claims experience as well as analyses of current claim obligations which the company and the auditor use to evaluate the adequacy of loss reserves. Among the most important dates that might affect loss reserve developments are the accident date, policy effective date, claim reporting date (date reported to company), claim recording date (date the claim is entered on the company's computer recording system), claim payment date, and claim reopening date (there may be more than one reopening date). Claims data must also be properly coded to meet the statutory reporting requirements of the annual statement and to provide statistics to support rate filings.

4.19 Smaller and "one-shot" claims are processed by less expensive methods. Usually a claim file is not prepared, and a separate reserve estimate is not recorded. All statistical and accounting matters are processed on the date of payment, and average reserve estimation methods are used between the report and settlement dates.

Claim Adjustment and Estimation

4.20 Claims adjusting involves (*a*) a field investigation, (*b*) an appraisal and negotiation of the claim subject to the appropriate supervision, and (*c*) approval by the company's claims department. Through an investigation, the adjuster determines, among other things, whether the claimed loss actually occurred, his or her estimate of the amount of the loss, whether the loss may be excludable under the terms of the policy, and whether the company has a right to recover part or all of the loss through salvage, or subrogation. Salvage is a contractual right of recovery that entitles the insurer to any proceeds from the disposal of damaged property for which the claim has been paid, such as the sale of a wrecked automobile to a junkyard. Subrogation is the legal right of the insurer to recover from a third party who may be wholly or partly responsible for the loss paid under the terms of the policy, such as recovery from an employee for the employer's loss covered by a fidelity bond.

4.21 Insurance companies use several different methods to adjust claims. Companies may use home or branch office adjusters, who are salaried employees of the company, or independent adjusters, who are professionals who charge fees for their investigation and adjustment service. Insurance companies may also join together to form an adjustment bureau to which they may refer claims. Subject to certain limitations, an adjustment bureau acts for each member company in the adjustment and negotiation of claims, with the company retaining the final authority for approval. Expenses of the adjustment bureau are shared among members, usually based on the number or dollar volume of claims referred to the bureau for adjustment. Most companies use a combination of methods to adjust claims. They may have a claim branch office established for closer supervision and better control of the cost of adjustments in territories in which they have a larger concentration of risks. In the territories in which their business does not warrant the establishment of a claim branch office, they may use independent adjusters or join an adjustment bureau.

4.22 As soon as practicable, an adjuster estimates the total expected amount that is payable on a claim. Such an estimate may be determined by the average cost per case based on experience for the line of business, or may be based on specific information on the individual case. The estimate is revised in response to changes in experience or as investigations progress and further information is received.

4.23 Companies have different approaches to establishing reserves on individual claim files. For some companies the case reserve represents the amount the company would pay as a settlement based on the facts in the file at that time. Reserves based on that approach tend, in the aggregate, to be inadequate to pay the ultimate cost of the reported claims. For other companies, the claim reserve represents a "worst-case" view of the injury and the liability or coverage issues presented by the case. Reserves based on this approach tend, in the aggregate, to exceed the ultimate cost of the reported claims.

4.24 For most companies, the philosophy intended for individual claim reserving falls between the examples described above. For purposes of establishing an appropriate financial statement reserve, the most important factors to consider are (*a*) the historical adequacy or inadequacy of total reserves, (*b*) the consistency in the reserving approach followed by the company, and (*c*) the availability of an actuarial/statistical analysis of reserves.

4.25 High jury awards, malpractice claims, structured settlements, and the proliferation of mass tort and latent injury claims, such as those for injuries caused by the environment and asbestos, have complicated the claim estimation process. Structured settlements potentially allow companies to ultimately pay lesser amounts on claims by purchasing annuities to pay settlements to claimants over future periods. The structured settlement allows a company to eliminate the reserve that was recorded for the claim, even if it exceeded the amount paid for the settlement. However, if the structured settlement is made to the claimant with recourse, the insurer is ultimately liable and should account for the structured settlement as reinsurance receivable from a retroactive reinsurance contract. Mass tort and latent injury claims have affected companies indirectly through their participation in pools and associations, such as the significant reserves that the industry had to provide for black-lung claims. The advent of such claims has required a higher level claims-review process. Most companies now use a variety of higher level reviews, such as those by claims committees and in-house counsel.

Claim Settlement

4.26 Claim and claim expense payments originate with signed proofs of loss, releases, medical bills, repair bills, or invoices for fees of independent adjusters or lawyers. When these documents are received, they are reviewed and compared with the claim files before payment is authorized. Authorized payments are then posted to the face sheets.

4.27 Methods of payment vary among insurance companies. Approved documents may be forwarded to the cashier for draft or check preparation, or the claim department may have authority to issue drafts. In many companies, authority to issue drafts may be given to field offices, adjusters, and sometimes agents; in those cases, copies of the drafts and related supporting documents are forwarded to the claims department. After processing, the supporting documents are filed in the related claim files.

4.28 Some companies record claims paid by checks or drafts when issued. Other insurance companies record claims paid when the drafts clear the bank. Source records are then forwarded to the data processing department for entry, usually in controlled batches, and totals of paid losses are posted to the general ledger. Changes in payment procedures or changes in the definition of payment date for coding purposes can affect loss reserve developments.

4.29 The treatment of structured settlements is different between SAP and GAAP. SSAP No. 65, paragraph 18 states "Statutory accounting and generally accepted accounting principles (GAAP) are consistent for the accounting of structured settlement annuities where the reporting entity is the owner and payee, and where the claimant is the owner and payee and the reporting entity has been released from its obligation. GAAP distinguishes structured settlement annuities where the owner is the claimant and a legally enforceable release from the reporting entity's liability is obtained from those where the claimant is the owner and payee but the reporting entity had not been released from its obligation. GAAP requires the deferral of gain resulting from the purchase of a structured settlement annuity where the claimant is the owner and payee yet the reporting entity has not been released from its obligation. Statutory accounting treats these settlements as completed transactions and considers the earnings process complete, thereby allowing for immediate gain recognition." Also see paragraph 19 of SSAP No. 65 for disclosure items for structured settlements.

Reinsurance Receivable

4.30 Upon receiving a notice of a claim, the claims department in conjunction with the reinsurance department generally determines whether there is any right of recovery under a reinsurance agreement. Daily reports show pro rata reinsurance information. Recoveries under quota-share reinsurance agreements are usually based on total claims figures period by period. Excess reinsurance is determined by claims adjusters based on reinsurance contracts. Reinsurance arrangements on liability policies may include provisions such that if aggregate claims from a common occurrence exceed a retention, then the excess amounts are covered by the reinsurer. Recoveries under such aggregate excess reinsurance treaties are coded similarly to catastrophe claims. (Chapter 6 describes reinsurance contracts.)

4.31 When it is determined that there will be reinsurance receivable on a claim, the estimated amount receivable is usually recorded in the claim file and the data processing records. Notices of losses are sent to the reinsurers in accordance with terms of the reinsurance contracts. Although some reinsurance contracts contain provisions for immediate recovery for losses over a stated amount, recoveries are normally settled monthly or quarterly, sometimes by being deducted from the premiums due to the reinsurers.

Salvage and Subrogation

4.32 After a claim has been settled, the possibility of salvage or subrogation may exist. Perhaps the simplest approach to determining the anticipated receivable is to estimate loss reserves using loss data that is net of salvage and subrogation recoveries. Many of the reserving methods for losses and loss-adjustment expenses, however, can also be used to estimate salvage and subrogation recoveries.

Claims Transaction Flow

4.33 The claims transaction flow in an insurance company is summarized as follows:

a. The insured reports the loss to his or her agent or directly to the company. If the insuring company has a central loss-reporting facility, the agency instead places the insured in contact with the facility, which will obtain the details of the loss from the insured and prepare a loss report. Insurance companies usually have separate departments to handle such claims; larger companies may even have separate departments to handle each kind of claim.

b. The loss is assigned a claim number and entered, either manually or through IT media, on the company's loss register. Claim numbers are generally assigned sequentially or by policy number.

c. A file is established to accumulate pertinent data and correspondence.

d. Concurrent with establishing a file, a copy of the policy (called the daily) under which the claim is being made is examined to determine the amount of coverage and whether the claimant was, at the time of occurrence, insured against the kind of loss suffered. The copy of the daily may be included in the claim file for further reference and documentation.

e. An adjuster is assigned to investigate the loss. The adjuster may be an employee of the insurance company, its agent, or an independent professional. The adjuster helps determine the amount of loss, estimate the reserve required, and provide information such as photographs, police reports, medical reports, statements of witnesses, and any other pertinent items to substantiate the loss.

f. A reserve (case outstanding) is established for the estimated dollar amount of loss that will ultimately be paid on the claim. Reserves are difficult to estimate because in some cases the severity of a loss or the effects of injuries, which may become apparent at some future time, are not readily subject to current determination. Many companies have minimum, maximum, or average amounts of reserves established for reported claims derived from their experience of past claim settlements.

g. Reinsurance applicable to the claim is reviewed, and reinsurance-receivables are established if the claim is subject to the terms of a reinsurance agreement; if necessary, the reinsurers are notified. If salvage or subrogation rights may be available, the appropriate notation and controls should also be posted.

h. After negotiation with the claimant, a check or draft is issued for the amount of the adjusted claim. On receipt of payment, the claimant generally signs a release indicating that final settlement has been received.

i. If reinsurance applies, loss payments receivable are posted to the appropriate control for summary reporting to the reinsurers or, if necessary, a proof of loss requesting payment is prepared and forwarded to the reinsurers.

Components of Loss Reserves

4.34 Loss reserves are an insurer's estimate of its liability for the unpaid costs of insured events that have occurred. An insurance company's loss reserves consist of one or more of the components described below. All of these components should be considered in the loss-reserving process but may not have to be separately estimated.

Case-basis reserves—The sum of the values assigned by claims adjusters to specific known claims that were recorded by the insurance company but not yet paid at the financial statement date. This chapter describes the most common methods used by companies to establish case-basis reserves.

Case-development reserves—The difference between the case-basis reserves and the estimated ultimate cost of such recorded claims. This component recognizes that case-basis reserves, which are estimates based on incomplete or preliminary data, will probably differ from ultimate settlement amounts. Accordingly, a summation of case-basis reserve estimates may not produce the most reasonable estimate of their ultimate cost.

Incurred but not reported (IBNR)—The estimated cost to settle claims arising from insured events that occurred but were not reported to the insurance company as of the financial statement date. This component includes reserves for bulk provisions or claims "in transit," that is, claims reported to the company but not yet recorded and included in the case-basis reserve. Bulk provisions are reserves included with other IBNR reserves to reflect deficiencies in known case reserves.

Reopened-claims reserve—The cost of future payments on claims closed as of the financial statement date that may be reopened due to circumstances unforeseen at the time the claims were closed.

Sometimes, case-development reserves, IBNR, and the reopened-claims reserve are calculated as a single reserve and broadly referred to as IBNR. In addition to the basic components of loss reserves, a company will also need to estimate the effect of the following components:

Reserves for loss adjustment expenses (LAE) represent expected payments for costs to be incurred in connection with the adjustment and recording of losses. SSAP No. 55, paragraph 5 notes that loss adjustment expenses can be classified as "Defense and Cost Containment

(DCC) and Adjusting and Other (AO). DCC includes defense, litigation, and medical cost containment expenses, whether internal or external. AO are those expenses other than DCC. . . . And include but are not limited to the following items: (*a*) Fees and expenses of adjusters and settling agents, (*b*) Loss adjustment expenses for participation in voluntary and involuntary market pools if reported by calendar year, (*c*) Attorney fees incurred in the determination of coverage, including litigation between the reporting entity and the policyholder; and (*d*) Fees and salaries for appraisers, private investigators, hearing representatives, reinspectors and fraud investigators, if working in the capacity of an adjuster."

Reduction for salvage—The estimated amount receivable by the insurer from the disposition of damaged or recovered property. Potential salvage on paid and unpaid losses should be considered in this estimate.

Reduction for subrogation—The estimated amount receivable from third parties from whom the insured may have the right to recover damages. The insured, having collected benefits from the insurer, is required to subrogate such rights to the insurer.

Drafts outstanding—Some insurance companies may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.

Reserves for assessments based on paid losses—The estimated amount of future assessments relating to payments on losses incurred prior to the financial statement date. An example is assessments by state workers' compensation second-injury funds.[2] In practice some companies included such assessments as losses, while others record them as taxes. SSAP No. 35, *Guaranty Fund and Other Assessments*, requires that companies record changes in the reserve in taxes, licenses and fees.

Reinsurance receivables—Amounts that will be recovered from reinsurers for losses and LAE accrued, including IBNR losses accrued. Amounts receivable from reinsurers on paid and unpaid losses are generally classified as assets.

4.35 Many insurance companies do not separately value each of the reserve components listed above. Frequently, an insurance company's reserve for case development is combined with its reserve for IBNR claims. Reinsurance and other recoveries may be netted against claim payments in the insurance company's records. In those situations, initial reserve estimates are also net of recoveries; separate analysis is then performed to determine the appropriate amount to record as the reinsurance receivable asset. DCC may be combined with loss payments and included in these components.

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[2] SOP 97-3 provides guidance on accounting by insurance and other enterprises for assessments used to fund second-injury funds. See appendix S of this guide.

Estimating Methods*

4.36 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical analyses of historical experience and are commonly referred to as loss reserve projections.

4.37 Loss reserve projections are used to develop loss reserve estimates. Understanding and assessing the variability of these estimates and the reliability of historical experience as an indicator of future loss payments require a careful analysis of the historical loss data and the use of projection methods that are sensitive to the particular circumstances.

4.38 The data used for projections is generally grouped by line of business and may be further classified by attributes such as geographic location, underwriting class, or type of coverage to improve the homogeneity of the data within each group. The data is then arranged chronologically. The following are dates that are key to classifying the chronology of the data.

Policy date—The date on which the contract becomes effective (also referred to as the underwriting date).

Accident date—The date on which the accident (or loss) occurs.

Report date—The date on which the company first receives notice of the claim.

Record date—The date on which the company records the claim in its statistical system.

Closing date—The date on which the claim is closed.

4.39 After the data has been grouped by line of business and by chronology, it may then be arrayed to facilitate the analysis of the data, highlight trends, and permit ready extrapolation of the data. The following are examples of types of data that are commonly arrayed and analyzed:

- Losses paid
- Losses incurred
- Case reserves outstanding
- Claim units reported
- Claim units paid
- Claim units closed
- Claim units outstanding
- DCC paid
- DCC outstanding
- Salvage and subrogation recovered
- Reinsurance recovered
- Reinsurance receivable
- Premiums earned
- Premiums in force
- Exposures earned
- Policies in force

* An Auditing Interpretation to SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 9312), expands the guidance of SOP 92-4, *Auditing Insurance Entities' Loss Reserves*. Readers should refer to these publications for additional information.

4.40 The data may be cumulative or incremental, gross or net of reinsurance, gross or net of salvage and subrogation, or combined with DCC data. The data may be stratified by size of loss or other criteria. Because claim data and characteristics such as dates, type of loss, and claim counts significantly affect reserve estimation, controls should be established over the recording, classification, and accumulation of historical data used in the determination of loss reserves. Exhibit B-2 in appendix B of the audit guide presents examples of such control activities.

4.41 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models. Projection methods basically fall into three categories:

- Extrapolation of historical loss dollars
- Projection of separate frequency and severity data (the number of claims that will be paid or closed and the average costs of these claims)
- Use of expected loss ratios

4.42 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.

4.43 Following is a brief summary of some commonly used projection methods.

Method	*Basis*
Loss Extrapolation	
Paid loss	Uses only paid losses. Outstanding case reserves are not considered.
Incurred loss	Uses paid losses plus reserves on outstanding claims.
Average Severities	Uses various claim count and average cost per claim data on either a paid or incurred basis.
Loss Ratio	Uses various forms of expected losses in relation to premiums earned.

4.44 The decision to use a particular projection method and the results obtained from that method should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of these assumptions to the circumstances. Stability and consistency of data are extremely important. Changes in variables, such as rates of claim payments, claim department practices, case-basis reserving adequacy, claim reporting rates, mix of business, reinsurance retention levels, and the legal environment, may have a significant effect on the projection and may produce distortions or conflicting results. Reference should be made to the section in this chapter titled "Changes in the Environment" [paragraphs 4.63 through 4.66] for a discussion of how changes in variables may affect the loss-reserving process. The results of any projection should be reviewed for reasonableness by analyzing the resultant loss ratios and losses per measure of exposure.

Illustrative Projection Data

4.45 The following tables are simple illustrations of the use of the loss extrapolation method to estimate ultimate losses, as well as the effects of considering the results of more than one projection. In these illustrations, the result of extrapolating incurred-loss data is compared with the result of extrapolating paid-loss data. These tables are presented solely for the purpose of illustrating the mathematical mechanics of the two projections. They do not illustrate the required analysis of the data, and consideration of internal and external environmental variables that may affect the claim payment and loss reserving process.

4.46 Table 1 presents an illustration of historical incurred-loss data. It reflects, as an example, that the sum of paid losses and case reserves outstanding at the end of 20X0 was $2,054; that sum increased to $2,717 in the next year and increased to $3,270 five years later.

4.47 This incurred-loss data is first used to calculate historical period-to-period incurred-loss development factors. These factors are used to compare the amount of incurred losses at successive development stages, and are illustrated in table 2, part 1.

4.48 The calculation of average historical period-to-period incurred-loss development factors may be based on the use of simple averages of various period-to-period factors or may be based on more complex weighting or trending techniques. These techniques can significantly affect the reserving process and require judgment, understanding, and experience. In this example, a simple average of the latest three period-to-period factors has been calculated and is presented in table 2, part 2.

Table 1

Case-Basis Incurred-Loss Data as of 12/31/X9

	Development Period (in months)									
Accident Year	*12*	*24*	*36*	*48*	*60*	*72*	*84*	*96*	*108*	*120*
20X0	$2,054	$2,717	$2,979	$3,095	$3,199	$3,348	$3,270	$3,286	$3,299	$3,301
20X1	2,213	2,980	3,269	3,461	3,551	3,592	3,631	3,643	3,651	
20X2	2,341	3,125	3,513	3,695	3,798	3,849	3,872	3,876		
20X3	2,492	3,502	3,928	4,177	4,313	4,369	4,392			
20X4	2,964	4,246	4,859	5,179	5,315	5,376				
20X5	3,394	4,929	5,605	5,957	6,131					
20X6	3,715	5,433	6,162	6,571						
20X7	4,157	5,912	6,771							
20X8	4,573	6,382								
20X9	4,785									

4.49 Once historical period-to-period incurred-loss development factors are calculated, future period-to-period incurred-loss development factors must be selected. The future period-to-period factors must reflect anticipated differences between historical and future conditions that affect loss development, such as changes in the underlying business, different inflation rates, or case-basis reserving practices. In the example, no differences are anticipated and the average historical factors have been chosen as the selected factors as shown in table 2, part 2. The selected future period-to-period factors are then used to produce ultimate incurred development factors. The ultimate factors are presented in table 2, part 3.

Table 2

Period-to-Period Incurred-Loss Development Factors as of 12/31/X9

Accident Year	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	Est. Tail[3]
	Development Period (in months)									
Part 1: Period-to-Period Historical Loss Development Factors										
20X0	1.323[4]	1.096	1.039	1.034	1.047	0.977	1.005	1.004	1.001	
20X1	1.347	1.097	1.059	1.026	1.012	1.011	1.003	1.002		
20X2	1.335	1.124	1.052	1.028	1.013	1.006	1.001			
20X3	1.405	1.122	1.063	1.033	1.013	1.005				
20X4	1.433	1.144	1.066	1.026	1.011					
20X5	1.452	1.137	1.063	1.029						
20X6	1.462	1.134	1.066							
20X7	1.422	1.145								
20X8	1.396									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Selected Factors										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Part 3: Ultimate Development Factors Selected for the Projection										
	1.828[5]	1.281	1.125	1.056	1.026	1.014	1.007	1.004	1.001	1.000

4.50 The loss reserve analysis has now reached the point where an initial projection of ultimate losses, as well as an indicated provision for unreported losses for each accident year, can be made by using the historical incurred-loss data and the ultimate incurred-loss development factors. This initial projection of ultimate losses is presented in table 3.

4.51 Tables 4 and 5 present paid-loss data for the same company whose incurred-loss data was presented in table 1. The array of paid-loss period-to-period development factors presented in table 5 is derived from table 4 using the same calculation methods used for incurred losses in table 2. The importance of the use of a tail factor in this calculation is apparent from the period-to-period historical loss development factors calculated in table 5. The tail factor represents an estimate of the development of losses beyond the period covered by the data array. In this instance, a tail factor of 1.01 was selected to project an additional 1 percent of losses to be paid from the tenth development year to ultimate. Selection of a tail factor requires careful judgment based on consideration of company and industry experience for the line of business, actuarial studies, case reserves, and any other relevant information.

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[3] Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.000 in this illustration).

[4] The 24-month developed losses are divided by the 12-month developed losses from table 1 ($2,717/$2,054 = 1.323).

[5] The product of the remaining factors (1.427 × 1.139 × 1.065 × 1.029 × 1.012 × 1.007 × 1.003 × 1.003 × 1.001 × 1.000 = 1.828) or the product of the 12-24 selected factor times the 24-36 ultimate factor (1.427 × 1.281 = 1.828).

4.52 The initial projection of ultimate losses, using the historical paid losses and the paid-loss ultimate development factors, is presented in table 6.

4.53 Table 7 compares the results of extrapolating paid-loss data (table 6) with the results of extrapolating incurred-loss data (table 3).

4.54 Although all accident periods should be analyzed and trends evaluated, it is clear that additional analysis of accident year 20X9 losses is required. The difference between the results obtained from the two different projections is significant. Initial inspection will trace the source of the difference to the high level of losses paid in 20X9 for accident year 20X9 relative to case-basis incurred losses for the same period. The loss reserving analysis must focus on whether the increase in payments represents an acceleration of payment activity or an increase in the overall level of losses incurred in 20X9. The benefit of using more than one projection is that it allows for this kind of analysis and comparison in the evaluation of loss reserves.

Table 3

Incurred-Loss Projection as of 12/31/X9

Accident Year	*Case-Basis Incurred Loss as of 20X9*[6]	*Ultimate Incurred-Losses Development Factors*[7]	*Projected Ultimate Losses (2) × (3)*	*Projected Unreported Loss (4) − (2)*
(1)	(2)	(3)	(4)	(5)
20X0	$ 3,301	1.000	$ 3,301	$ 0
20X1	3,651	1.001	3,655	4
20X2	3,876	1.004	3,892	16
20X3	4,392	1.007	4,423	31
20X4	5,376	1.014	5,451	75
20X5	6,131	1.026	6,290	159
20X6	6,571	1.056	6,939	368
20X7	6,771	1.125	7,617	846
20X8	6,382	1.281	8,175	1,793
20X9	4,785	1.828	8,747	3,962
Total	$51,236		$58,490	$7,254

[6] From table 1.

[7] From table 2, part 3.

Table 4

Paid-Loss Data as of 12/31/X9

Accident Year	*Development Period (in months)* 12	24	36	48	60	72	84	96	108	120
20X0	$ 896	$1,716	$2,291	$2,696	$3,041	$3,096	$3,185	$3,235	$3,262	$3,276
20X1	872	1,840	2,503	2,973	3,261	3,429	3,538	3,589	3,624	
20X2	968	1,975	2,683	3,185	3,494	3,670	3,763	3,819		
20X3	968	2,130	2,968	3,571	3,942	4,147	4,274			
20X4	1,201	2,580	3,673	4,421	4,860	5,114				
20X5	1,348	2,996	4,207	5,115	5,632					
20X6	1,340	3,146	4,520	5,496						
20X7	1,384	3,428	4,960							
20X8	1,568	3,696								
20X9	2,243									

Table 5

Period-to-Period Paid-Loss Development Factors as of 12/31/X9

Accident Year	*Development Period (in months)* 12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	Est. Tail[8]
Part 1: Period-to-Period Historical Loss Development Factors[9]										
20X0	1.915	1.335	1.177	1.128	1.018	1.029	1.016	1.008	1.004	
20X1	2.110	1.360	1.188	1.097	1.052	1.032	1.014	1.010		
20X2	2.040	1.358	1.187	1.097	1.050	1.025	1.015			
20X3	2.200	1.393	1.203	1.104	1.052	1.031				
20X4	2.148	1.424	1.204	1.099	1.052					
20X5	2.223	1.404	1.216	1.101						
20X6	2.348	1.437	1.216							
20X7	2.477	1.447								
20X8	2.357									
Part 2: Period-to-Period Average Development Factors										
Simple Average of Latest Three										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Selected Factors										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Part 3: Ultimate Development Factors Selected for the Projection[9]										
	5.127	2.142	1.499	1.237	1.123	1.069	1.039	1.023	1.014	1.010

[8] Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.010 in this illustration).

[9] Computations are the same as those explained in table 2.

Table 6

Paid-Loss Projection as of 12/31/X9

Accident Year	*Paid Losses as of 20X9*	*Ultimate Loss Development Factors*	*Projected Ultimate Losses (2) × (3)*	*Projected Unreported Losses*[10]
(1)	(2)	(3)	(4)	(5)
20X0	$ 3,276	1.010	$ 3,309	$ 8
20X1	3,624	1.014	3,675	24
20X2	3,819	1.023	3,907	31
20X3	4,274	1.039	4,439	47
20X4	5,114	1.069	5,465	89
20X5	5,632	1.123	6,325	194
20X6	5,496	1.237	6,796	225
20X7	4,960	1.499	7,434	663
20X8	3,696	2.142	7,916	1,534
20X9	2,243	5.127	11,500	6,715
Total	$42,134		$60,766	$9,530

Table 7

Alternative Projections of Ultimate Losses and Unreported Losses as of 12/31/X9

Accident Year	*Ultimate Losses*		*Unreported Losses*	
	Incurred	*Paid*	*Incurred*	*Paid*
20X0	$ 3,301	$ 3,309	$ 0	$ 8
20X1	3,655	3,675	4	24
20X2	3,892	3,907	16	31
20X3	4,423	4,439	31	47
20X4	5,451	5,465	75	89
20X5	6,290	6,325	159	194
20X6	6,939	6,796	368	225
20X7	7,617	7,434	846	663
20X8	8,175	7,916	1,793	1,534
20X9	8,747	11,500	3,962	6,715
Total	$58,490	$60,766	$7,254	$9,530

Loss Adjustment Expense Reserves

4.55 Loss adjustment expense reserves are the costs that will be required to settle claims that have been incurred as of the valuation date. As explained in paragraph 4.34, loss adjustment expenses (LAE) can be classified into two broad categories: Defense and Cost Containment (DCC) and Adjusting and Other (AO).

[10] Represents the projected losses from table 6, column 4, less the recorded case-basis incurred losses from table 3, column 2.

DCC Reserve Calculation Approaches

4.56 DCC is generally analyzed by line of business. A shift in the composition of the costs in relation to the total might affect the statistical data used in the related loss projections. This shift would need to be considered in future loss reserve projections.

4.57 Many companies calculate DCC reserves based on the relationship of DCC to losses. Underlying this approach is a basic assumption that DCC will increase or decrease in proportion to losses. The setting of reserves for DCC based on the relationship of paid DCC to paid losses is referred to as the "paid-to-paid ratio" approach. Separate ratios are normally developed for each accident year. Inflation in DCC is not typically evaluated separately; rather, it is estimated to occur at the same rate as the rate of inflation in the losses. The validity of this assumption can be tested by reviewing historical relationships between DCC and losses over time. The effects of a pattern of increasing or decreasing ratio of DCC to losses should be considered in establishing DCC reserves. An understanding of the claim department's operations and philosophy over time is essential to a proper interpretation of the data.

4.58 Other approaches to DCC reserve calculation and analysis include (*a*) analyzing DCC entirely apart from the related loss costs using methods that compare the development of DCC payments at various stages and (*b*) using combined loss and DCC data in situations where it appears likely that this would produce more accurate estimates (e.g., when the company has changed its claim defense posture so that defense costs increase and loss costs decrease). In this latter approach, statistical tests and projections are based on the combined data for losses and DCC.

4.59 Some companies establish case-basis reserves for certain types of DCC or increase case-basis loss reserves by a stated percentage to provide for DCC. In either case, additional DCC reserves should be provided for the development of case-basis reserves and IBNR.

AO Reserve Calculation Approaches

4.60 AO reserves are often provided for by using the calendar year paid-to-paid method rather than the accident year paid-to-paid method used for DCC reserves. Although the paid-to-paid ratios establish the relationship of the AO payments to the loss payments, the timing of the AO payments is also critical to estimation of the AO reserves. For example, some companies assume that a portion of AO costs is incurred when a claim is placed on the books and the remaining portion is incurred when the claim is settled. For reported claims, the cost of placing the claim on the books has been incurred, so it is only necessary to provide a reserve for the remaining portion at settlement. For IBNR claims, it is necessary to provide for all of the AO. Some companies perform internal studies to establish the methods and ratios to be used in their calculations.

4.61 The AO reserves should provide for inflation. The assumption that AO will inflate at a rate equal to the rate at which losses inflate should be periodically reviewed. The rate should also be adjusted for expected technological or operational changes that might cause economies or inefficiencies in the claim settlement process.

4.62 If paid-to-paid AO ratios will be calculated for each line of business, a reasonable basis for allocating paid AO by line of business should be established.

Changes in the Environment

4.63 Loss reserve projections are used to estimate loss reporting patterns, loss payment patterns, and ultimate claim costs. An inherent assumption in such projections is that historical loss patterns can be used to predict future patterns with reasonable accuracy. Because many variables can affect past and future loss patterns, the effect of changes in such variables on the results of loss projections should be carefully considered.

4.64 Identification of changes in variables and consideration of their effect on loss reserve projections are critical steps in the loss reserving process. The evaluation of these factors requires the involvement of a loss reserve specialist as well as input from various operating departments within the company such as the marketing, underwriting, claims, actuarial, reinsurance, and legal departments. Management's use of a specialist in determining loss reserves is discussed in paragraphs 4.67 through 4.70 of this chapter.

4.65 Variables to be considered in evaluating the results of loss reserve projections include those variables affecting inherent and control risk described in appendix A. If changes in variables have occurred, mechanical application of loss projection methods may result in unreasonable estimates of ultimate claim costs. Changes in variables can be considered in the loss reserving process in a variety of ways, including—

- *Selection of loss projection method(s).* Loss projection methods vary in their sensitivity to changes in the underlying variables and to the length of the claim emergence pattern. When selecting a loss projection method, consideration should be given to how a change in the underlying data will affect that method. For example, if management has adopted a policy to defer or accelerate the settlement of claims, a paid-loss extrapolation method will probably produce unreliable results. In that case, an incurred-loss extrapolation or other methods may produce better estimates of ultimate losses.
- *Adjustment of underlying historical loss data.* In certain cases, the effect of changed variables can be isolated and appropriately reflected in the historical loss data used in the loss projection. For example, if policy limits are relatively consistent for all policies in a block of business, and if these limits have recently been reduced by a constant amount, historical loss data can be adjusted to exclude amounts in excess of the revised policy limits.
- *Further segregation of historical loss data.* Certain changes in variables can be addressed by further differentiating and segregating historical loss data. For example, if a company begins to issue claims-made policies for a line of business for which it traditionally issued occurrence-basis policies, segregation of data between the two types of policies should minimize the effect of the different reporting patterns. Such segregation should produce more accurate loss reserve projections for the occurrence-basis policies. (However, loss development data relating to the claims-made policies will be limited in the initial years.)
- *Separate calculation of the effect of variables.* The effect of certain changes in variables can be isolated and separately computed as an adjustment to the results of other loss projection methods. For example, if claim cost severity has increased (an increase in auto repair costs) or is expected to increase beyond historic trends, an additional reserve can be separately computed to reflect the effect of such actual or anticipated increases.

- *Qualitative assessments*. In many instances, the magnitude or effect of a change in a variable will be uncertain. The establishment of loss reserves in such situations requires considerable judgment and knowledge of the company's business.

The development of environmental and similar claims may not follow the usual development pattern of general liability claims, with which they are usually grouped. When the activity of these claims is sufficient to distort the recorded development of the company, the distorting activity should be isolated from the development history so that an accurate projection of the remaining claims can be made. Management's process of assessing its environmental and similar exposure should include procedures to—

- Ensure that all data elements are recorded on each incoming claim or precautionary notice.
- Assess the company's exposure to these types of liability claims by considering such factors as the types of risks historically written, layers of coverage provided, the policy language employed, and recent decisions rendered by courts.
- Determine whether any portion of potential liability costs is probable and reasonably estimable.

4.66 FASB Statement No. 5 and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies.

Use of Specialists by Management in Determining Loss Reserves

4.67 Management is responsible for making the accounting estimates included in the financial statements. As explained in the previous sections of this chapter, the process of estimating loss reserves is complex and involves many subjective judgments. Accordingly, the determination of loss reserves should involve an individual with a sufficient level of competence and experience in loss reserving, including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of appropriate methods available for calculating loss reserve estimates. These individuals are referred to as "loss reserve specialists" in this chapter. The specialist's level of competence and experience should be commensurate with the complexity of the company's business, which is affected by such factors as the kind(s) of insurance underwritten and the environmental and risk considerations listed in appendix A. Criteria that may be considered in determining whether an individual qualifies as a loss reserve specialist include the aforementioned as well as the following:

- Knowledge of various projection techniques, including their strengths and weaknesses and applicability to various lines of insurance
- Knowledge of changes in the environment in which the company operates, including regulatory developments, social and legal trends, court decisions, and other factors described in more detail in the appendix and the effect that these factors will have on the emergence and ultimate cost of these claims

4.68 The Casualty Actuarial Society (CAS) offers a course of study and examinations that are designed to train individuals to be, among other things, loss reserve specialists. In addition, the American Academy of Actuaries establishes qualification standards for its members who practice in this area. Although many casualty actuaries may therefore be qualified to be loss reserve specialists, other individuals, through their experience and training, may also be qualified. Training and experience should provide individuals with knowledge about different policy forms and coverages, current developments in insurance, and environmental factors that might affect the loss reserving process. Training and experience should also provide individuals with knowledge that will enable them to apply appropriate methods of estimating loss reserves. The extent of this knowledge and ability should be commensurate with the complexity and kinds of business written.

4.69 Many insurance companies use loss reserve specialists who are employees or officers of the company. In addition, many companies engage consulting casualty actuaries to either assist in the determination of the loss reserve estimate or to perform a separate review of the company's loss reserve estimate. The scope of work to be performed by the consulting actuary is a matter of judgment by company management. Usually, the consulting actuary will issue a report summarizing the nature of the work performed and the results. Since 1990, the Annual Statement Instructions have required a Statement of Actuarial Opinion relating to loss and loss adjustment expense reserves.

4.70 Because the process of estimating loss reserves is complex and involves many subjective judgments, the absence of involvement by a loss reserve specialist in the determination of management's estimate may constitute a reportable condition and possibly a material weakness in the entity's internal control. Auditors of public companies are precluded from providing primary actuarial capabilities. SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended by SAS No. 87, *Restricting the Use of an Auditor's Report*, describes the auditor's responsibility to communicate reportable conditions to the audit committee. A discussion of the auditor's use of loss reserve specialists is included in paragraph 4.67 of this chapter.

Guaranty Fund and Other Assessments

4.71 State guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations, subject to prescribed limits, of insolvent insurance enterprises. The assessments are generally based upon premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (*a*) to fund operating expenses of state insurance regulatory bodies and (*b*) to fund second-injury funds. SOP 97-3 provides guidance on accounting for guaranty-fund and other assessments related to insurance activities.

Auditing Loss Reserves

Auditing the Claims Data Base

4.72 The historical experience of an insurance entity is generally the primary source of information on which loss reserve estimates are based; therefore, the creation of reliable data bases, within an insurance company, is extremely critical to the determination of loss reserve estimates. When evaluating loss reserves, the auditor should consider the reliability of the historical information generated by the insurance company.

4.73 The auditor should determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of the loss data; assess control risk for assertions about loss reserves; and determine the nature, timing, and extent of substantive tests that will be performed for these assertions. Because claim data and characteristics such as dates and type of loss can significantly influence reserve estimation, the auditor should test the completeness, accuracy, and classification of the claim loss data. Exhibit B-2 in appendix B of this guide provides more extensive guidance on auditing the claims cycle.

Evaluating the Reasonableness of the Estimate

Selecting an Audit Approach

4.74 SAS No. 57 states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. The loss reserve estimate is a significant estimate on the financial statements of an insurance entity. Accordingly, regardless of the approach used to audit the loss reserve estimate, the auditor should gain an understanding of how management developed the estimate. The auditor should use one or a combination of the following approaches in evaluating the reasonableness of the accounting estimates:

a. Review and test the process used by management to develop the estimate.

b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.

c. Review subsequent events or transactions occurring prior to completion of fieldwork.

4.75 When auditing loss reserve estimates, usually approach *a*, *b*, or a combination of the two is used. Normally, approach *c* alone is insufficient to provide reasonable assurance because claims are usually reported to insurance companies and settled over a period of time extending well beyond a normal opinion date. However, approach *c* may provide additional information concerning the reasonableness of loss reserve estimates, particularly for short-tail lines of business, when used in combination either with approach *a* or *b* or with both.

4.76 When planning the audit, the auditor chooses to use either approach *a* or *b*, or a combination of both approaches, depending on his or her expectation of what approach will result in sufficient competent evidential matter in the most cost-effective manner. Either approach can be used and, depending on client circumstances, either approach may be effective. However, when management has not used the services of a loss reserve specialist in developing its loss reserve estimate, approach *a*, reviewing and testing management's process, is not appropriate. In this circumstance, approach *b*, developing an independent expectation, should be used.

Reviewing and Testing the Process Used by Management to Develop the Estimate

4.77 The auditor may assess the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. This approach may be appropriate when loss reserve estimates are recommended by an outside loss reserve specialist and management accepts those recommendations, when loss reserve specialists employed by the company are responsible for recommending the estimates, or when both outside and internal specialists are used.

4.78 A company that uses an outside loss reserve specialist to develop loss reserve recommendations may engage the specialist to evaluate only the company's major lines of business or only certain components of the loss reserves. In either circumstance, the auditor should determine whether a different approach is needed for auditing the items not reported on by the loss reserve specialist.

4.79 If the auditor reviews and tests the process used by management to develop its estimate, and management's estimate differs significantly from the recommendations developed by its specialists, appropriate procedures should be applied to the factors and assumptions that resulted in the difference between management's estimate and the specialists' recommendations. Such procedures should include discussion with management and its specialists. It is management's responsibility to record its best estimate of loss reserves in the financial statements.

4.80 SAS No. 57 identifies the following as procedures the auditor may consider performing when using this approach. Some of the procedures listed below apply to the process management uses to supply data to the loss reserve specialist, some apply to the process used by the specialist to develop recommendations, some apply to the process used by management to review and evaluate those recommendations, and some apply to the process management uses to translate the specialist's recommendations into the loss reserve estimates recorded in the financial statements.

a. *Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.*

   Controls over the preparation of accounting estimates may include—

   - Procedures for selecting independent loss reserve specialists or hiring internal specialists, including procedures for determining that the specialist has the requisite competence in loss reserving, knowledge of the company's types of business, and understanding of the different methods available for calculating loss reserve estimates.
   - Procedures for reviewing and evaluating the recommendations of the loss reserve specialist.
   - Procedures to ensure that the methods used to calculate the loss reserve estimate are appropriate and sufficient in the circumstances.

Controls over the preparation of supporting data, in addition to those discussed in exhibit B-2 in appendix B of this guide, may include—

   - Procedures for verifying that data used by the loss reserve specialist is appropriately summarized and classified from the company's claims data base.

- Procedures for ensuring that data actually used by the loss reserve specialist is complete and accurate.
- Procedures to substantiate and determine the appropriateness of industry or other external data sources used in developing assumptions (for example, data received from involuntary risk pools).

b. *Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose, based on information gathered in other audit tests.* Sources of data and factors used may include—
   - Company historical claims data from its own data bases, including changes and trends in the data.
   - Company information on reinsurance levels and changes from prior years' reinsurance programs.
   - Data received from involuntary risk pools such as those administered by the National Council on Compensation Insurance.
   - Industry loss data from published sources.
   - Internal company experience or information from published sources concerning recent trends in socioeconomic factors affecting claim payments, such as—
     — General inflation rates and specific inflation rates for medical costs, wages, automobile repair costs, and the like.
     — Judicial decisions assessing liability.
     — Judicial decisions regarding noneconomic damages.
     — Changes in legislation affecting payment levels and settlement practices.

Consider whether the company's data is sufficient to have adequate statistical credibility (e.g., to allow the "law of large numbers" to work for the company's estimates). Consider whether the types of industry data used in developing assumptions are relevant to the company's book of business, considering policy limits, reinsurance retention, geographic and industry concentrations, and other appropriate factors.

c. *Consider whether there are additional key factors or alternative assumptions about the factors.* Key factors and potential alternative assumptions that might be considered include—
   - Changes in the company's experience or trends in loss reporting and settlements. Increases in the speed of the settlement of claims may lead to assumptions that paid development levels will be lower in the future, or may indicate changes in the company's procedures for processing claims that could lead to increased development in the future.
   - Divergence in company experience relative to industry experience. Such divergence might later result in company development experience that reduces the divergence or might be indicative of a change in a company's experience with a book of business.
   - Changes in a company's practices and procedures relating to recording and settling claims.

- A company's reinsurance programs and changes therein.
- Changes in a company's underwriting practices such as new or increased use of managing general agents.
- New or changed policy forms or coverages.
- Recent catastrophic occurrences.

d. *Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.* Assumptions that should be evaluated include not only explicit assumptions but also the assumptions inherent in various loss projection methods.
   - Paid loss projection methods assume that a company's historical experience relating to the timeliness of settlement will be predictive of future results.
   - Reported (incurred) loss development projection methods assume that a company's experience in estimating case-basis reserves will be repeated in the future.

e. *Analyze historical data used in developing the assumptions to assess whether it is comparable and consistent with data of the period under audit, and consider whether the data is sufficiently reliable for the purpose.* Consider whether the company's past methods of estimating loss reserves have resulted in appropriate estimates and whether current data (for example, current-year development factors) indicate changes from prior experience. Consider how known changes in the company's loss reporting procedures and settlement practices have been factored into the estimate. Consider how changes in reinsurance programs, in the current period and during historical periods, have been factored into management's estimates.

f. *Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.* Consider such changes as—
   - New lines of business and classes of business within lines.
   - Changes in reinsurance programs.
   - Changes in the regulatory environment, such as premium rate rollbacks and regulation.
   - Changes in the method of establishing rates and changes in methods of underwriting business.

g. *Review available documentation of the assumptions used in developing the accounting estimates, inquire about any other plans, goals, and objectives of the entity, and consider their relationship to the assumptions.* A company's practices concerning loss settlement, such as a practice of vigorously defending suits or of quickly settling suits, can have a significant effect on a company's loss experience.

h. *Consider using the work of a specialist regarding certain assumptions.* Using the work of a specialist is discussed in SAS No. 73, *Using the Work of a Specialist,* and in paragraphs 4.103 through 4.105 of this chapter.

i. *Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.* Consider whether all lines of business and accident years are included in the loss reserve estimate. Consider how reinsurance receivable, salvage, and subrogation have been included.

Developing an Independent Expectation of the Estimate

4.81 Based on his or her understanding of the facts and circumstances, the auditor may independently develop an expectation of the estimate by using other key factors or alternative assumptions about those factors. This approach is required whenever management has not used the services of a loss reserve specialist in developing its loss reserve estimate and may be appropriate to assist the auditor in assessing the variability of the loss reserve estimates, even when management does use a loss reserve specialist. The auditor frequently develops independent projections because this method may result in a more cost-effective method of obtaining sufficient competent evidential matter.

4.82 When this approach is used, the auditor should use an outside loss reserve specialist (the auditor may also be a loss reserve specialist) to develop the independent expectation of the loss reserve estimate. The use of a specialist is discussed in paragraphs 4.105 through 4.107 of this chapter.

Analytical Procedures*

4.83 Various analytical procedures may be used in the evaluation of loss reserve trends and data, such as the analysis of—

- Loss ratios.
- Loss frequency and severity statistics.
- Claim cost by exposure units.
- Adequacy/redundancy of prior year reserves.
- Average case reserves.
- Claim closure rates.
- Paid to incurred ratios.

4.84 Such analyses include comparison of trends and data with industry averages or other expectations. Evaluation would normally be performed by line of business and accident or report year.

Loss Reserve Ranges

4.85 As stated in SAS No. 57:

> Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.
>
> Accordingly, loss reserves may develop in a number of ways and a reserve for a particular line of business or accident year may prove to be redundant or deficient when analyzed in a following period. Loss reserves considered to be adequate in prior periods may need to

* SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU secs. 312, 329, 339, and 341), among other matters, amends SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), to add a documentation requirement to SAS No. 56. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. Additionally, the AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures. The Audit Guide includes a discussion of SAS No. 56, concepts and definitions, a series of questions and answers, and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis.

be adjusted at a later date as a result of events outside the control of the insurance company that create the need for a change in estimate. Such events include future court decisions and periods of inflation, in which rates may change significantly from period to period and affect the payout of claims. As a result of the circumstances described above, the need to adjust loss reserve estimates in future periods because of future events that are not predictable at the balance sheet date should not be interpreted as evidence of an error or poor loss reserving practices in the past.

4.86 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. An audit approach should address the inherent variability of loss reserve estimates and the effect of that variability on audit risk. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. An analysis of the reasonableness of loss reserve estimates ordinarily should include an analysis of the amount of variability in the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst-case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range).

4.87 Another way to address the variability of the loss reserve estimate is to develop a best estimate and to supplement it with qualitative analysis that addresses the variability of the estimate. Qualitative analysis involves consideration of the factors affecting the variability of loss reserves and integrating such factors into a determination of the range of reasonable estimates around a best estimate. Such factors, among others, include the mix of products underwritten, losses incurred by the insurance industry for similar coverages and underwriting years, and the correlation between past and current business written. In any analysis, a thorough working knowledge of the risk factors is a prerequisite to setting a realistic range. Whether the auditor prepares a formal reserve range or a selected estimate, factors affecting the variability of the recorded loss reserve should be considered. The audit procedures performed for this purpose will vary based on the characteristics of the business, the controls the company uses to monitor such variability, and other audit procedures used.

4.88 The size of the loss reserve range will vary by line of business. For example, automobile physical damage claims may be estimated with greater precision than product liability claims. In extreme cases, the top-to-bottom range could extend to 50 percent and upward of the amount provided. An example of an extreme case might be a newly formed company that writes primarily volatile types of business. The results of operations in such a situation are sensitive to future fluctuations since the loss reserve estimate is based primarily on assumptions that will undoubtedly change over time. More important, however, is the strain that any extremely adverse loss development would place on such a company's surplus. In an opposite extreme case, the top-to-bottom range might only be 5 percent of the amount provided for a company that only writes automobile physical damage coverages.

4.89 When evaluating the variability of loss reserves for an entity, the auditor should be aware that variability within an individual risk group or line of business may be mitigated by the variability within other risk groups or lines of business. In other words, it is unlikely that ultimate claim settlements for each line of business will fall at the same end of the range.

Risk Factors and Developing a Range

4.90 Because loss reserves represent both reported and unreported claims that have occurred as of the valuation date, the auditor needs to gain an understanding of the company's exposure to risk through the business it writes as well as an understanding of environmental factors that may affect the company's loss development at the valuation date.

4.91 Some risk factors existing within the company that may affect the variability of the company's loss reserves are—

- *The frequency and severity of claims associated with a line of business.* Medical malpractice, directors' and officers' liability, and other lines of business that typically produce few claims with large settlement amounts tend to have a high degree of variability.
- *Policy characteristics.* Individual lines of business can be written on different policy forms. For example, loss reserving and its related variability for medical malpractice written on an occurrence basis will differ markedly when the policy is written on a claims-made basis, especially during the early years of conversion from an occurrence to a claims-made basis.
- *Retention levels.* The greater a company's retention level, the more variable the results are likely to be. This increased variability is due to the effect that one or several large losses can have on the overall book of business. For reinsurance assumed, the concepts analogous to retention levels are referred to as attachment points and limits.
- The mix of a company's business with respect to long-tail liability lines and short-tail property lines. Typically, loss reserves on business with longer tails exhibit greater variability than on business with shorter tails because events affecting ultimate claim settlements may occur at a later date.

4.92 Some external factors that may affect the variability of loss reserves are—

- Catastrophes or major civil disorders.
- Jury awards and social inflation arising from the legal environment in principal states in which a company's risks are underwritten.
- The effect of inflation.

4.93 Other risk factors that may affect the variability of loss reserve estimates are described in appendix A.

4.94 The auditor should obtain an understanding of both internal and external risk factors. This may be accomplished by a review of contracts, inquiries of underwriters, a review of pertinent trade publications, and any other procedures deemed necessary under the circumstances. The auditor should consider these factors in evaluating a reasonable loss reserve range. The best estimate may not necessarily be midway between the highest and lowest estimates in the range, because certain factors (for example, risk retention limits and retrospectively rated contracts) may reduce the variability at one end of the range but not at the other.

4.95 When analyzing the variability of loss reserves, the auditor should be aware of potential offsets that may serve to reduce the financial statement effects of misstatements in the recorded loss reserves. Two common examples are ceded reinsurance and retrospectively rated contracts (primary or reinsurance). Such offsets, if material, should be included in an analysis of reserve ranges to quantify the true income statement or balance sheet effect that results from an increase or decrease in loss reserves.

4.96 As noted previously in the discussion of internal risk factors and per-risk retention levels, a lower net retention level typically would translate into a lower variability of reserves. In addition, the auditor should consider the workings of all significant reinsurance ceded contracts and the effect that these contracts have on best estimates and high and low points in a range. In considering the effect of reinsurance ceded agreements on loss reserves, the auditor should also consider the effect on ceded reinsurance premiums. See paragraphs 4.111 through 4.113 of this chapter for a discussion of the effects of ceded reinsurance on loss reserve estimates.

4.97 A retrospectively rated feature in an insurance contract means that increases or decreases in incurred losses may be wholly or partially offset by changes to earned but unbilled premiums. As a result of such a clause, an increase in loss reserves may lead to a receivable for additional premiums while a decrease in loss reserves may be offset by a reduction in premiums.

Evaluating the Financial Effect of a Reserve Range

4.98 To determine the amount of variability that is significant to the financial statements, the financial leverage of a company should be analyzed. Financial leverage refers to items such as reserve-to-surplus ratios. The financial position of a company with a 2-to-1 reserve-to-surplus ratio is less affected by variability in its loss reserves than is a company operating at a 4-to-1 ratio.

4.99 Additionally, an analysis comparing the difference between recorded loss reserves and the high and low ends of a range with key financial statement balances, such as surplus or recorded loss reserves, might be performed. Combining financial leverage with other materiality factors pertinent to the company (for example, loan covenant agreements) may provide insights into the amount of variability that is acceptable to the auditor. Because of the imprecise nature of estimating loss reserves, the acceptable range of loss reserve estimates will generally be higher than that of a more tangible balance such as accounts receivable or payable.

4.100 According to SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*,* "If the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between the estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements." Therefore, if the recorded loss reserve is outside a range of realistic estimates, the difference between the recorded reserve and the nearer end of the reasonable reserve range should be

* Statement on Auditing Standards (SAS) No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU secs. 312, 329, 339, and 341), among other matters, amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, to add a requirement to SAS No. 47 to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. This chapter of the Guide will be modified in a future edition of the Guide to reflect the requirements and terminology used in SAS No. 96.

treated as an audit difference. This audit difference should be considered with any other audit differences to evaluate the materiality of the effects on the financial statements. If the difference is deemed material, the auditor should first ask management for additional information that may have been overlooked in the original evaluation. Then, if still necessary, the auditor should attempt to persuade management to make an appropriate adjustment. If management does not make an appropriate adjustment, the auditor should consider modifying his or her report on the financial statements.

4.101 SAS No. 47* also states, "Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement." Accordingly, if the recorded loss reserve is within the reasonable range developed by the auditor, an audit adjustment may not be appropriate.

4.102 The significance of the variability within a reasonable reserve range should also be evaluated against the financial statements. If the difference between the company's recorded reserve and the farther end of the reserve range is deemed significant, the auditor should consider extending audit procedures to obtain additional evidential matter relating to the reserve estimate.

4.103 Management must select a single loss reserve estimate that represents its judgment about the most likely circumstances and events. If management develops a reasonable range, the amount recorded should be the best estimate within that range. The auditor should obtain an understanding of the process used by management in arriving at this estimate. In determining the reasonableness of loss reserves, the auditor also should consider the consistency of reserve estimates and any changes in the degree of conservatism of recorded reserves. A change in the degree of conservatism of management's estimate may be indicative of a change in management's reserve process. SAS No. 32, *Adequacy of Disclosure in Financial Statements,* discusses the auditor's responsibility to consider whether the financial statements include adequate disclosure of material matters in light of the circumstances and facts of which the auditor is aware.

Auditor Uncertainty About the Reasonableness of Management's Estimate and Reporting Implications

4.104 Ordinarily, the auditor would look to historical data to obtain evidential matter that will provide reasonable assurance that management's estimate of loss reserves is reasonable in the circumstances. Such historical data may not currently exist for certain new companies, for companies writing significant amounts of new lines of business, or for companies with a low volume of claims. When the historical data is not sufficient to resolve uncertainty about the reasonableness of management's estimate of loss reserves and the auditor is unable to resolve that uncertainty through other means, the auditor should consider whether management has adequately disclosed the

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* Statement on Auditing Standards (SAS) No. 96, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU secs. 312, 329, 339, and 341), among other matters, amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* to add a requirement to SAS No. 47 to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. This chapter of the Guide will be modified in a future edition of the Guide to reflect the requirements and terminology used in SAS No. 96.

uncertainty in the notes to the financial statements as required by FASB Statement No. 5 and paragraphs 4 and 6 of FASB Interpretation No. 14, and SOP 94-6. A matter involving an uncertainty is one that is expected to be resolved at a future date at which time conclusive evidential matter concerning its outcome would be expected to become available. Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

Use of Specialists by Auditors in Evaluating Loss Reserves

4.105 It is the auditor's responsibility to evaluate the reasonableness of the loss reserve established by management. The procedures that the auditor should consider in evaluating the reasonableness of the loss reserve are described in SAS No. 57. One of the procedures the auditor may consider in evaluating the reasonableness of the loss reserve is using the work of a specialist. SAS No. 73 provides guidance to the auditor who uses the work of a specialist in performing an audit of financial statements. It states that the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. The Statement also states that the auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. Although SAS No. 73 does not preclude the auditor from using the work of a specialist who is related to the client, because of the significance of loss reserves to the financial statements of insurance companies and the complexity and subjectivity involved in making loss reserve estimates, the audit of loss reserves requires the use of an outside loss reserve specialist, that is, a specialist who is not an employee or officer of the company. The term *loss reserve specialist* is defined in paragraphs 4.67 and 4.68 of this chapter. When the auditor has the requisite knowledge and experience in loss reserving, the auditor may serve as the loss reserve specialist. If the auditor does not possess the level of competence in loss reserving to qualify as a loss reserve specialist, the auditor should use the work of an outside specialist.

4.106 In accordance with SAS No. 73, whenever the auditor uses the work of a specialist, the auditor should fulfill certain fundamental requirements. The auditor should satisfy himself or herself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures. The auditor also should consider the relationship, if any, of the specialist to the client. An understanding should be established between the auditor, the client, and the specialist as to the scope and nature of the work to be performed by the specialist and the form and content of the specialist's report. The auditor has the responsibility to obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings of the specialist are suitable for corroborating representations in the financial statements. These responsibilities apply to all the situations described in paragraph 4.107.

4.107 The following are descriptions of situations involving the presence or absence of a loss reserve specialist in management's determination of loss reserves and the recommended response by the auditor in each situation.

Situation 1—The company has no loss reserve specialist involved in the determination of loss reserves.

Auditor response to situation 1—As stated in paragraph 4.70, this situation may constitute a reportable condition and possibly a material weakness in internal control. The auditor should use an outside loss reserve specialist to develop an independent expectation of the loss reserve estimate recorded by the company.

Situation 2—The company has an in-house loss reserve specialist who is involved in the determination of loss reserves and the company does not use an outside loss reserve specialist.

Auditor response to situation 2—The auditor would be required to use an outside loss reserve specialist to evaluate the reasonableness of the company's loss reserve estimate.

Situation 3—The company has no in-house specialist but involves an outside loss reserve specialist in the determination of loss reserves.

Auditor response to situation 3—The auditor should evaluate the relationship, if any, of the specialist to the company. If the specialist is related to the client, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should use an outside specialist for that purpose.

Situation 4—The company involves an in-house loss reserve specialist in the determination of loss reserves and involves an outside loss reserve specialist to separately review the loss reserves.

Auditor response to situation 4—The auditor could use the separate review performed by the outside loss reserve specialist.

Evaluating the Reasonableness of Loss Adjustment Expense Reserves

4.108 Evaluation of the reasonableness of LAE reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves; therefore, such an evaluation ordinarily requires the use of an outside loss reserve specialist. Frequently, both DCC reserves and AO reserves are calculated based on formulas related to paid losses; therefore, in conjunction with the audit of loss adjustment expenses, the auditor should perform sufficient procedures to obtain assurance about the reliability of the paid-loss data. Although DCC and AO frequently are calculated using formulas based on paid losses, they are calculated differently; accordingly, different procedures are used in the evaluation of these two types of reserves.

4.109 In most circumstances, a development test cannot be used as a test of the reasonableness of the AO reserve. The reasonableness of the AO reserve is primarily dependent on the application of sound techniques of cost accounting and expense allocation. The basis of this allocation should be reviewed by the auditor because the way that the company allocates its expenses will have an effect on the AO reserve calculation. This review should focus on the allocation of costs to the loss adjustment classification as well as the allocation within that classification to the individual lines of business.

Ceded Reinsurance Receivable

4.110 This section discusses certain concepts and procedures that the auditor should be aware of to make a proper evaluation of the reasonableness of reinsurance receivable. This section does not address the following items, which are discussed in chapter 6. Reference should be made to chapter 6 of this guide for information about—

- The purpose and nature of reinsurance.
- Forms and types of reinsurance.
- Generally accepted accounting practices for reinsurance transactions.
- Internal control considerations relating to ceded and assumed reinsurance and a description of audit procedures to verify the integrity of recorded transaction data pursuant to such agreements.

Understanding an Insurance Company's Reinsurance Program

4.111 Chapter 6 of this guide recommends that the auditor obtain an understanding of an insurance company's reinsurance program to properly perform audit procedures to verify the accuracy and completeness of recorded cessions and assess the ability of reinsurers to meet their financial obligations under such agreements. This understanding is also essential to properly evaluate the reasonableness of reinsurance receivable balances. The scope of this understanding should not be limited to the reinsurance program currently in effect but should also include reinsurance program(s) in effect during historical periods from which loss experience will be used to project current year ultimate losses and reinsurance recoveries.

4.112 Net loss development patterns will vary to the extent that current reinsurance arrangements (coverages, levels of retention, and type and form of reinsurance) differ from arrangements in effect during the claim experience period used to project losses. Accordingly, the effect of such differences on estimates of reinsurance receivables will need to be carefully assessed by the auditor. The level of complexity involved in making this assessment is largely dependent on the types of reinsurance used and the amount of experience available under the program.

4.113 Special difficulties arise in estimating reinsurance receivable on excess of loss reinsurance arrangements in which claim frequency is sporadic, retention levels have changed, and aggregate excess of loss arrangements are used. Estimates of reinsurance receivables are generally easiest for primary first dollar coverages (first dollar coverage of either property or casualty business). Additionally, relying on expected loss ratios as a guide for estimating recoveries on excess reinsurance arrangements will not be very helpful if the pricing of such arrangements has varied from year to year with little correlation to the underlying economics of these agreements. Some companies separately project reinsurance receivable on IBNR losses by stratifying the data base by size of loss.

Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises

Introduction

4.114 The AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, is a result of that project and has been amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification.*

Scope

4.115 SOP 94-5, as amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, applies to annual and complete sets of interim financial statements prepared in conformity with GAAP of property and casualty insurance enterprises as well as life and health insurance enterprises (including mutual life insurance enterprises), reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies.

Applicability to Statutory Financial Statements

4.116 AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards*, vol. 1, AU section 9623.60-.81), as amended, to SAS No. 62, requires auditors to apply the same disclosure evaluation criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.

Relationship to Other Pronouncements

4.117 In some circumstances, the disclosure requirements in SOP 94-5, as amended, may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), or the Securities and Exchange Commission (SEC). For example—

- FASB Statement No. 5 requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.
- FASB Statement No. 60 requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.
- FASB Statement No. 113 requires certain disclosures about reinsurance transactions.
- SOP 94-6 requires disclosures about certain significant estimates.

- The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in SOP 94-5, as amended, supplement the disclosure requirements in other authoritative pronouncements. SOP 94-5, as amended, does not alter the requirements of any FASB or SEC pronouncement.

Conclusions

4.118 The disclosure requirements in this section should be read in conjunction with "Illustrative Disclosures" (paragraph 4.126 through 4.129), and "Discussion of Conclusions," which is presented in appendix P of this guide.

Permitted Statutory Accounting Practices

4.119 The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised Accounting Practices and Procedures Manual (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of insurance enterprises should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

4.120 Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. A state may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

4.121 Permitted statutory accounting practices include practices not prescribed by the domiciliary state as described in paragraph 4.120 above, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practice, or (*b*) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

4.122 The disclosures in this paragraph should be made if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices. The disclosures should be made if the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed. If an insurance company's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[11]

Liability for Unpaid Claims and Claim Adjustment Expenses

4.123 The liability for unpaid claims and claim adjustment expenses represents the amounts needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (*a*) claims that have been reported to the insurer, (*b*) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (*c*) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims.

4.124 Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in incurred claims and claim adjustment expenses recognized in the income statement attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

4.125 In addition to the disclosures required by FASB Statement No. 5 and other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other mass tort and environmental exposures.

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[11] Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. GAAP financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority, and their monetary effects.

Illustrative Disclosures

4.126 The following illustrations are guides to implementation of the disclosures required by SOP 94-5. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of SOP 94-5.

Prescribed or Permitted Statutory Accounting Practices

4.127 Following are two examples of illustrative disclosures that an insurance enterprise could make to meet the requirements of SOP 94-5.

Note X. Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $2.5 million and $2.3 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was $30.0 million and $27.9 million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been $29.9 million and $27.7 million at December 31, 20X2 and 20X1, respectively.[1]

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[1] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

Note X. Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of the [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP.

The monetary effect on statutory capital and surplus of using accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department is as follows:

	December 31 20X2 $m	December 31 20X1 $m
Statutory capital and surplus per statutory financial statements	$30.0	$27.9
Effect of permitted practice of recording home office property at estimated fair value	(2.5)	(2.3)
Effect of [state of domicile's] prescribed practice of immediate write-off of goodwill[2]	2.4	2.1
Statutory capital and surplus in accordance with the NAIC statutory accounting practices[3]	$29.9	$27.7

[2] This amount compared to the prior year reflects the net impact of an additional year's amortization and the fact that admitted goodwill is based on the level of statutory capital and surplus and thus can fluctuate.

[3] In the initial year of implementation of this disclosure, prior year amounts for the effect or permitted practices and prescribed practices should be disclosed as required under the original SOP 94-5.

Liability for Unpaid Claims and Claim Adjustment Expenses

4.128 The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph 4.124. (This illustration presents amounts incurred and paid net of reinsurance. The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

Note X. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	20X2	*20X1*
Balance at January 1	$7,030	$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	5,796	5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	$6,799	$7,030

As a result of changes in estimates of insured events in prior years, the claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in 20X2 and 20X1, respectively) decreased by $171 million in 20X2 reflecting lower-than-anticipated losses on Hurricane Howard, and increased by $96 million in 20X1 reflecting higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

4.129 The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph 4.125. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB Statement No. 5, FASB Interpretation 14, *Reasonable Estimation of the Amount of a Loss*, SOP 94-6, and SEC requirements.)

Note X. Environmental and Asbestos Related Claims

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

Chapter 5

The Investment Cycle

5.01 A property and liability insurance company functions as a conduit of funds. It collects funds from those desiring protection from financial loss and disburses funds to those who incur such losses. During the period between receipt of funds and the payment of losses, the property and liability insurance company invests the funds.

5.02 The assets of a property and liability insurance company consist mainly of investments in bonds, stocks, mortgage loans, and real estate.

Regulation

5.03 Because insurance companies have a public responsibility to be able to meet their obligations to policyholders, state insurance statutes and regulations prescribe standards and limitations on investment activities. Regulatory requirements and restrictions vary by state. Most states require insurance companies to invest a certain percent of reserves in specified classes of investments. Once the minimums are met, the company may invest in other kinds of investments. Most states, however, specify a maximum percentage of assets that may be invested in particular classes of investments. State regulations may also prescribe methods for reporting investments, set requirements regarding matters such as the location and safeguarding of assets, and set limitations on investing in futures, futures contracts, and options. For example, a regulatory authority may require some investments to be deposited with the state insurance department as a condition for writing business in that state. Insurance statutes and regulations vary by state, but the regulations of the state of domicile have precedence; however, substantial compliance provisions in states such as New York must also be followed. The auditor should obtain an understanding of the statutory requirements concerning investments of the company that could affect the company's intent to hold certain investments to maturity.

Investment Alternatives

5.04 Insurers plan their investment strategy to complement their insurance business. Funds are invested so that the income from investments plus maturities meets the ongoing cash flow needs of the company. This approach, one of matching assets and liabilities, requires a correct mix of long- and short-term investments and is generally referred to as asset and liability management.

Short-Term Investments

5.05 In addition to holding long-term investments consisting of bonds, stocks, real estate, and mortgages, insurance companies generally maintain short-term portfolios consisting of assets with maturities of less than one year to meet liquidity needs. Short-term investments of property and liability insurance companies typically consist of commercial paper, certificates of deposit, Treasury bills, and money market funds.

5.06 *Repurchase agreements.* The use of repurchase agreements (repos) as a short-term investment has gained widespread acceptance. Repos involve the purchase of securities by the insurance company (lender) with the stipulation that they will be repurchased by the seller (borrower) at a specified price within a specified time. In such transactions, the underlying securities may be received by the lender or a third-party custodian; they may also be designated or held by the borrower on behalf of the lender as "collateral." The maturity of the agreement is fixed by the contract and depends on the needs of the borrower and the willingness of the lender. For example, agreements may be structured on a day-by-day basis whereby the terms are negotiated daily.

5.07 The difference between the purchase price and the repurchase price, or sale price, plus accrued interest on the security represents investment income.

5.08 If the criteria in paragraph 9 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, are met, the transferor should account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee should account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred assets that should be accounted for as sales include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferee has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement assets.

5.09 Furthermore, wash sales that previously were not recognized if the same financial asset was purchased soon before or after the sale should be accounted for as sales under FASB Statement No. 140. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

5.10 *Securities lending.* Insurance companies occasionally loan their bonds and stocks to securities brokers or dealers for temporary purposes, generally to cover a broker's short-sale or fail transactions, the latter arising when securities are not delivered in proper form. In exchange for lending the securities, the company should receive cash collateral from the broker in an amount equal to or exceeding the market values of the securities on that day; this collateral is immediately invested for the company's benefit. The market values of the securities on loan should be closely monitored, and changes in excess of an agreed-upon range cause the release of the collateral or an increase in collateral. Securities lending has no effect on the valuation of securities for statutory accounting purposes, provided the amount of the collateral at least equals the required collateral as specified by the NAIC; however, if the collateral is less than required, the value of the securities would be written down.

5.11 In some securities lending transactions the criteria in paragraph 9 of FASB Statement No. 140 are met, and consideration other than beneficial interests in the transferred assets is received. Those transactions should be accounted for (*a*) by the transferor as a sale of the loaned securities for proceeds consisting of the cash collateral and a forward repurchase commitment and (*b*) by the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor has a claim only to the collateral and the forward repurchase commitment.

5.12 However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets. Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed and reclassified as set forth in paragraph 15(a) of FASB Statement No. 140, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

5.13 The transferor of securities being loaned accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being loaned accounts for those securities in the same way as it would account for cash received.

Other Investment Alternatives

5.14 Insurance companies have been increasingly attracted to alternative investments as part of their overall investment management strategy. Among these alternatives are futures contracts stock options, and similar financial instruments.

5.15 *Futures contracts.* Investments in futures contracts are gaining widespread acceptance as a means to hedge against market risk and help maintain a company's liquidity. Futures contracts are legal agreements between buyers or sellers and clearinghouses of futures exchanges; they represent commitments to buy or sell financial instruments at specified dates and prices.

5.16 *Options on equity securities.* In recent years, option writing by insurance companies has increased. State laws and regulations differ on the kinds of options, if any, that insurance companies are permitted to write, but some states permit insurance companies to write *covered-call options*. These are options for securities that insurance companies own and can deliver if the options are exercised by the option buyers. If an insurance company writes a covered-call option, it transfers to the option buyer the right to benefit from appreciation of the security underlying the option above the exercise price. Insurance companies usually write covered-call options because they consider the premium received for writing the options to be either (*a*) an economic hedge against a decline in the market price of the underlying security or (*b*) an increase in yield on the underlying security.

The Transaction Cycle

5.17 The investment cycle includes all functions relating to the purchase and sale of investments. The cycle encompasses investment income and gains and losses, as well as custody of investment and recordkeeping. The functions within this cycle may be segregated into separate subcycles for each major kind of investment (such as bonds, stocks, mortgages, and real estate) because of the different activities and considerations for each kind.

5.18 Except for differences caused primarily by the regulatory environment and investment objectives, the investment transaction cycle of property and liability insurance companies is generally similar to that found in other financial services industries.

Investment Evaluation

5.19 Most insurance companies have separate investment departments responsible for managing the companies' investable funds. The evaluation and subsequent purchase or sale of investments is based on the judgment of the company's investment and finance committees. Typically, the finance committee, which usually consists of top-level management, is responsible for all investment activity. An investment committee of the company's investment department is usually assigned the duty of evaluating investment transactions. In addition to such factors as market conditions, interest rates, and risk, the evaluation of investments includes consideration of the company's investment objectives, current and projected cash flows, and relevant state regulations. When regulatory compliance is in question, the transaction ordinarily should be referred to the legal department for evaluation.

Safekeeping

5.20 An insurance company's treasury department is usually responsible for the safekeeping of securities. Securities are either stored in a company vault to which access is limited to authorized personnel or are held in the custody of banks, securities depositories, or state departments of insurance. Coupon-bearing securities may be arranged in the vault by payment date to ensure that they are redeemed on a timely basis.

Recordkeeping

5.21 Investment-cycle journal entries are a basic input for the company's financial statements. Journal entries should be prepared accurately and promptly to ensure that the financial statements include all transactions in the proper period.

5.22 The accounting department prepares an investment purchases and sales journal, as well as interest-income and dividend-income lists. This information is recorded on a cash basis and is reconciled monthly with cash receipts and disbursements listed in the cashier's department. At the end of the period, journal entries are made to convert the information to the accrual basis by accruing for interest earned and dividends declared but not received and by recording investment transactions with trade dates before the end of the period but not settled until after that period ends.

5.23 IT applications are used to record most data relating to investment activity. Investment service reports and evaluation data (such as yield and income analyses, expected income, and market rate changes) may be produced by the computer and can provide management with an important source of information for the evaluation of investments. Management reports can be generated that indicate whether investments owned are in compliance with regulatory requirements. Key performance indicators utilized by management to monitor investing activities include: securities by type, maturity distributions, quality ratings, investment yields, realized and unrealized gains and losses, and non-performing statistics.

Accounting Practices

5.24 The specialized industry accounting principles for investments of insurance companies are specified in FASB Statement No. 60, as amended by FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. FASB Statement No. 97 establishes reporting standards for insurance enterprises of realized gains and losses on investments. FASB Statement No. 115, as amended by FASB Statement No. 133, establishes standards of financial accounting and reporting by insurance companies for investments in equity securities that have readily determinable fair values and for all investments in debt securities. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*[1] (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance to auditors in auditing investments in debt and equity securities and investments accounted for under APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. FASB Statement No. 115 requires that those investments to which it applies be classified in three categories at acquisition and that the appropriateness of the classification be reassessed at each reporting date. The categories established by FASB Statement No. 115 are as follows:

- Held-to-maturity securities[2, 3]
- Trading securities
- Available-for-sale securities

Held-to-Maturity Securities

5.25 Held-to-maturity securities are those debt securities for which the entity has the positive intent and ability to hold to maturity. Held-to-maturity securities should be measured at amortized cost. Amortized cost is the original cost of the security, reduced by amortization of premiums or increased by accretion of discounts. Amortization should be calculated using the interest method, which results in a constant effective yield. Other methods of amortization may be used only if the results obtained are not materially different from those that would result from the interest method. The current-year amortization or accretion should be recorded as a charge or credit to investment income.

5.26 FASB Statement No. 115 recognizes that, while sales or transfers of these debt securities should be rare, there are certain changes in, circumstances that may cause an entity to change its intent to hold a certain debt security to maturity. The Statement lists changes in circumstances that might prompt an entity to transfer a debt security classified as held-to-maturity to another category without calling into question its intent to hold other debt securities to maturity in the future. Events other than those listed in the

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[1] The companion Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing SAS No. 92.

[2] Paragraph 7 of FASB Statement No. 115, as amended by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, states that a security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment.

[3] Paragraph 4t(1) of FASB Statement No. 135, *Recission of FASB Statement No. 75 and Technical Corrections*, requires a held-to-maturity debt security to be evaluated in accordance with paragraphs 12 to 16 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to determine whether it contains an embedded derivative that must be accounted for separately.

Statement may lead to permissible transfers as long as the events are "isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated." Payments of catastrophic claims by a property and liability insurer generally would not be considered such an event.

5.27 When debt securities are transferred from the held-to-maturity category to the trading category, the portion of the unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings should be recognized in earnings immediately. When a debt security is transferred from the held-to-maturity category to the available-for-sale category, the unrealized holding gain or loss should be reported in other comprehensive income. When debt securities are transferred from the trading category to the held-to-maturity category, the unrealized holding gain or loss will have already been recognized in earnings and should not be reversed. When debt securities are transferred from the available-for-sale category to the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity, such as accumulated other comprehensive income, but should be amortized over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount.

5.28 The following information should be disclosed regarding the sale or transfer of any debt securities classified as held-to-maturity—

- the net carrying amount of the security sold or transferred,
- the related realized or unrealized gain or loss, and
- the circumstances leading to the decision to sell or transfer the security.
- the net gain or loss in accumulated other comprehensive income for any derivative that hedged the forecasted acquisition of the held-to-maturity security.

Realized gains and losses on sales of securities classified as held-to-maturity should continue to be reported in the income statement as a component of other income, on a pretax basis, in accordance with paragraph 28 of FASB Statement No. 97.

Trading Securities

5.29 Trading securities are debt and equity securities that are bought and held principally for the purpose of selling them in the near term. Trading securities should be measured at fair value in the statement of financial position, with unrealized holding gains and losses included in earnings. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be used in applying FASB Statement No. 115 is the product of the number of trading units of the instrument times its market price.

5.30 Paragraph 6 of FASB Statement No. 65, as amended by FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, requires that after the securitization of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of FASB Statement No. 115. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitization process.

5.31 FASB Statement No. 115 notes that given the nature of trading securities, transfers into or from the trading category should also be rare. However, when such transfers occur, they should be accounted for as follows—

- When securities are transferred from the trading category to either the held-to-maturity category or the available-for-sale category, the unrealized holding gain or loss at the date of the transfer will already have been recognized in earnings and should not be reversed.
- When securities are transferred into the trading category from either the held-to-maturity category or the available-for-sale category, the portion of the unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings should be recognized in earnings immediately.

Available-for-Sale Securities

5.32 Available-for-sale securities are debt and equity securities that are not classified as either trading securities or held-to-maturity securities. Available-for-sale securities should be measured at fair value, with unrealized holding gains and losses excluded from earnings and reported as a net amount in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraph 22 of FASB Statement No. 133. Realized gains and losses on sales of securities classified as available-for-sale should continue to be reported in the income statement as a component of other income, on a pretax basis, in accordance with paragraph 28 of FASB Statement No. 97.

5.33 Accounting for transfers of securities between the available-for-sale category and other categories is described in paragraphs 5.28 and 5.32 above.

Impairment of Securities

5.34 FASB Statement No. 115 requires that entities determine whether declines in the fair values of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. (If a security has been the hedged item in a fair value hedge, the security's "amortized cost basis" shall reflect the effect of the adjustments of its carrying amount made pursuant to paragraph 22(b) of FASB Statement No. 133.) The Statement notes that if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other than temporary impairment shall be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in other comprehensive income pursuant to paragraph 13 of FASB Statement No. 115; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in other comprehensive income.

5.35 The following guidance discusses declines in the values of securities that are other than temporary. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, investments in debt and equity securities, and investments accounted for under APB Opinion No. 18. Its companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementation. Additionally, SEC Staff Accounting Bulletin (SAB) No. 59, *Accounting for Noncurrent Marketable Equity Securities* (Topic 5M), sets forth the SEC staff's interpretation of the phrase "other than temporary." The SEC's staff does not believe that "other than temporary" should be interpreted to mean permanent. Topic 5M states that if a decline in market value has occurred, management should determine whether a write-down should be recorded. In evaluating whether a write-down should be recorded, numerous factors should be considered, including the following:

- The length of time and extent to which the market value has been less than cost
- The financial condition and near-term prospects of the issuer, including any specific events that may influence its operations
- The intent and ability of the company to retain its investment for a period of time sufficient to allow for any recovery in market value

5.36 The SEC has issued Financial Reporting Release No. 36, *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, which sets forth the commission's views concerning several disclosure matters, such as disclosures for participation in high-yield financing, highly leveraged transactions, or non-investment-grade loans and investments, that should be considered by registrants in preparing management's discussion and analysis.

5.37 Mortgages are reported at amortized cost. Premiums or discounts are generally amortized over the mortgage loan contract (or in some cases, a shorter period based on estimated prepayment patterns) in a manner that will result in a constant effective yield. Interest income and amortization amounts that are recognized as an adjustment of yield are included as components of interest income. Commitment fees should be amortized on a straight-line basis over the commitment period and recognized as service fee income. Amounts included in income on the expiration of the commitment period should also be recognized as service fee income. Loan origination fees should be recognized over the life of the related loan as an adjustment of yield using the interest method. The property and liability insurance company should recognize the impairment of a mortgage loan by creating a valuation allowance with a corresponding charge to bad debt expense or by adjusting an existing valuation allowance with a corresponding charge or credit to bad debt expense. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, addresses the accounting by creditors for impairment of certain loans.

5.38 Real estate investments are reported at cost, less accumulated depreciation and an allowance for any impairment in value. Depreciation should be charged or credited to investment income. Changes in the allowance for impairment of value should be included in realized gains and losses. Allowances for uncollectible interest for mortgages and income from real estate investments are generally recorded against investment income.

5.39 FASB Statement No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. Those standards are based on consistent application of a *financial-components approach* that focuses on control. Under that approach, after a transfer of financial assets, an entity recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets when control has been surrendered, and derecognizes liabilities when extinguished. FASB Statement No. 140 provides consistent standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings.

5.40 A transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

b. Each transferee (or if the transferee is a qualifying SPE, each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.

c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

5.41 FASB Statement No. 140 requires that assets obtained and liabilities incurred by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

5.42 FASB Statement No. 140 requires that servicing assets and liabilities be subsequently measured by (*a*) amortization in proportion to and over the period of estimated net servicing income or loss and (*b*) assessment for asset impairment or increased obligation based on their fair values.

5.43 FASB Statement No. 140 requires that debtors reclassify financial assets pledged as collateral.

5.44 FASB Statement No. 140 requires that a liability be derecognized if and only if either (*a*) the debtor pays the creditor and is relieved of its obligation for the liability or (*b*) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.

5.45 FASB Statement No. 140 provides implementation guidance for assessing isolation of transferred assets and for accounting for transfers of partial interests, servicing of financial assets, securitizations, transfers of sales-type and direct financing lease receivables, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, risk participations in banker's acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities.

Accounting for Derivative Instruments and Hedging Activities

5.46 FASB Statement No. 133, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, and FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those investments at fair value. If certain conditions are met, a derivative may be specifically designated as (*a*) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (*b*) a hedge of the exposure to variable cash flows of a forecasted transaction, or (*c*) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB Statement No. 133 (paragraphs 44–47) also contains extensive disclosure requirements. Readers should refer to the full text of the Statement when considering accounting and reporting issues related to derivative instruments and hedging activities. The FASB has established the Derivatives Implementation Group (DIG) to assist the Board and its staff in providing implementation guidance regarding FASB Statement No. 133. Below is a list of insurance specific DIG issues. Issues addressed by the DIG and the status of related guidance can also be found at the FASB's Web site at www.fasb.org.

- Issue B7 Variable Annuity Products and Policyholder Ownership of the Assets
- Issue B8 Identification of the Host Contract in a Nontraditional Variable Annuity Contract
- Issue B9 Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options
- Issue B10 Equity-Indexed Life Insurance Contracts
- Issue B25 Deferred Variable Annuity Contracts with Payment Alternatives at the end of the Accumulation Period
- Issue B26 Dual-Trigger Property and Casualty Insurance Contracts
- Issue B27 Dual-Trigger Financial Guarantee Contracts
- Issue B28 Foreign Currency Elements of Insurance Contracts
- Issue B29 Equity-Indexed Annuity Contracts with Embedded Derivatives
- Issue B30 Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts
- Issue B31 Accounting for Purchases of Life Insurance
- Issue B34 Period Certain Plus Life Contingent Variable Payout Annuity Contracts With a Guaranteed Minimum Level of Periodic Payments

Statutory Accounting Practices

5.47 Under SAP, common stock is generally reported at the NAIC market value published in the Valuations of Securities Manual, which is the determination of "market" for each listed stock by the NAIC's Securities Valuation

Office. Preferred stock shall be classified into six quality categories in accordance with the Purposes and Procedure Manual of the NAIC Securities Valuation Office. As noted in SSAP No. 32, *Investments in Preferred Stock* (excluding investments in preferred stock of subsidiary, controlled, or affiliated entities), paragraph 16, "Preferred stock shall be valued based on (*a*) the underlying characteristics of the security, (*b*) the quality rating of the security as defined in the NAIC *Purposes and Procedures of the Securities Valuation Office* (Purposes and Procedures of the SVO) and reported in the NAIC *Valuations of Securities* manual, and (*c*) whether an Asset Valuation Reserve (AVR) is maintained by the reporting entity. Unrealized gains and losses on perpetual preferred stock shall be included as a direct credit or charge to unassigned funds (surplus)." Perpetual preferred stock that are of highest or high quality (designation 1 or 2) and have characteristics of equity securities, shall be valued at cost. All other perpetual preferred stocks (with designations 4 to 6) shall be reported at the lower of cost, amortized cost or fair value. For any decline in the fair value of common or preferred stocks that is deemed other than temporary, the equity security shall be written down to fair value as the new cost basis. The amount of the write down should be accounted for as a realized loss. Common and preferred stocks acquisitions and dispositions shall be recorded on the trade date, private placement stock transactions shall be recorded on the funding date. A description and the amount of common or preferred stock that is restricted and the nature of the restriction is required to be disclosed. Both SSAP No. 30, *Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)*, and SSAP No. 32, reject FASB Statement No. 115. Common and preferred stocks are also subject to both qualitative and quantitative limitations as defined by the state of domicile to qualify as admitted assets. Insurers are required to submit newly acquired unlisted securities, not subject to the provisional exemption filing rule, to the NAIC Securities Valuation Office for valuation. Under the provisional exemption rule, an insurer determines if a security is eligible for exemption based upon a three-part test. If the insurer claims the security is eligible, it may list the security on the statutory investment schedule as an NAIC 1 or 2 with a PE symbol.

5.48 For equity securities not listed in the NAIC *Purposes and Procedures of the Securities Valuation Office*, or listed with no value, it is the responsibility of management to determine a fair value that can be substantiated to the appropriate NAIC subcommittee or regulatory agency based on analytical or pricing mechanisms. The property and casualty entity is required to submit sufficient information on these securities to the NAIC Securities Valuation Office for a determination of fair value.

5.49 SSAP No. 46, *Investments in Subsidiary, Controlled, or Affiliated Entities*,* requires that investments in subsidiary, controlled or affiliated (SCA) entities be reported using either a market valuation approach or equity methods. There are specific requirements to use the market valuation approach, including the requirement to record at a discount to market (the requirements can be found in SSAP No. 46, paragraph 7a). Under the equity method, investments in insurance SCA entities shall be recorded based on statutory equity of the respective entity's financial statements; investments in

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* Issue Paper No. 118, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46*, has been exposed for comment. Issue Paper No. 118 clarifies when either the statutory or GAAP equity basis should be used. If adopted as a SSAP, companies may need to change the valuation basis of their noninsurance and foreign insurance subsidiaries. Readers should be alert to any final pronouncement.

noninsurance SCA entities that have "no significant ongoing operations other than to hold assets primarily for the direct or indirect benefit or use of the reporting entity or its affiliates" should be recorded based on statutory equity. Investment in SCA entities that "have significant ongoing operations beyond the holding of assets that are primarily for the direct or indirect benefit of the reporting entity" should be recorded based on GAAP equity (SSAP No. 46, paragraph 7b defines the different types of investments). As defined in SSAP No. 46, paragraph 13d, "if financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period." The rule requires judgment by the reporting entity in making the determination and provides flexibility to the regulator in analyzing the determination. Under the statutory or GAAP equity methods, the share of undistributed earnings and losses of an investee shall be included in unrealized gains and losses of the reporting entity. Other changes in the investee surplus are also recorded as a component of unrealized capital gains and losses on investment. Dividends or distributions received shall be recognized in income when declared with a concurrent adjustment to the investment account and unrealized capital gains and loses. The carrying amount of the investment shall be reduced to the extent dividends declared are in excess of undistributed accumulated earnings.

5.50 Under statutory accounting practices, qualifying debt securities are subject to the valuation standards of the NAIC, as described in the NAIC's Purposes and Procedures of the Security Valuation Office Manual of the NAIC Security Valuation Office. The securities shall be carried at amortized cost, except for those with an NAIC designation of 3 to 6, which shall be reported at the lower of amortized cost or fair value. As with GAAP, amortization or accretion under SAP is calculated by the interest method. An acquisition or disposal of a debt security shall be recorded on the trade date, except for private placement bonds which shall be recorded on the funding date. An impairment that is considered other than temporary shall be recorded as a realized loss, and should result in the cost basis of the security being written down to the fair value as a new cost basis. As noted in SSAP No. 26, paragraph 9, "Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual." Interest income determined to be uncollectible shall be written off through the summary of operations, and an evaluation should be made to determine nonadmitted amounts. Under SAP, a collectibility test similar to GAAP is used to determine whether an impairment of investment income exists, as explained in SSAP No. 34, *Investment Income Due and Accrued*. If the interest is deemed uncollectible, the amount should be written off and charged against investment income in the current period. Interest not related to mortgage loans, which is deemed collectible, is considered nonadmitted if ninety days or more past due.

5.51 Requirements for carrying debt securities as admitted assets vary at the discretion of the states. A debt security must be classified as a nonadmitted asset if it fails a qualitative or quantitative limitation test or is otherwise unauthorized by the applicable state code.

5.52 The NAIC Codification has not incorporated the concepts of FASB Statement Nos. 133 and 138, but the NAIC Statutory Accounting Principles

Working Group is considering the application of the FASB derivative concepts for statutory purposes. Any new guidance is expected to be effective no earlier than January 1, 2003. Under SAP, derivatives are defined as swaps, options, futures, caps, floors, and collars. SSAP No. 31, *Derivative Instruments*,* provides definitions for these terms.

5.53 Under the NAIC Codification, derivatives used in hedging activities should be accounted for in a manner consistent with the item hedged (i.e., if the item being hedged is accounted for at amortized cost, the hedging derivative also is accounted for at amortized cost). Derivatives that do not qualify for hedge accounting are accounted for using the mark to market method. SSAP No. 31,* paragraph 22 states, "Under the immediate recognition method of accounting (i.e. mark to market), changes in fair value from one reporting period to another reporting period shall be recognized currently in earnings. The immediate recognition method of accounting (mark to market) shall be applied in situations where:

a. A reporting entity enters into a derivative for other than hedging purposes;

b. A portfolio has been hedged and the reporting entity is unable to assign the hedging instrument to specific assets and liabilities;

c. There are derivatives that are not specifically addressed elsewhere in this guidance."

5.54 Any unrealized gains or losses on options that hedge assets carried at market value, such as separate accounts or contracts not intended as hedges, are recorded as unrealized gains or losses. Unrealized gains or losses under the mark to market method are recognized in earnings.

5.55 For gain or loss upon termination, SSAP No. 31,* paragraph 20 states, "Upon termination of a derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the hedging derivative may be realized and shall be subject to IMR upon termination. Reporting entities shall account for a derivative at estimated fair value if it ceases to be effective as a hedge (that is, the gains and losses on the derivative no longer offset the losses and gains on the hedged instrument) and recognize the gain or loss current in earnings."

5.56 Under SAP, the amount recorded as the initial investment in a loan is the principal of the loan, net of deferred loan origination and commitment fees. If purchased, the loan is recorded at the amount paid, net of premium or discount. Some states stipulate maximum loan values that limit the extent to which outstanding principal balances can be reported as admitted assets, and most states have restrictions that apply to the size of the individual loan in relation to the appraised value of the mortgaged property either at the origination date, the current valuation date, or both.

5.57 Procedures for amortizing discounts and premiums on mortgage loans are included in SSAP No. 37, *Mortgage Loans*. Loan commitment fees are deferred, and shall be amortized over the life of the loan if the commitment is exercised. If the commitment is not exercised, the fee should be recognized in

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* The SAP Working Group has exposed for comment SSAP No. 86, *Accounting for Derivative Instruments and Hedging Activities*, which contains certain concepts of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. If adopted, the statement will supersede SSAP No. 31. Readers should be alert to any final pronouncement.

income on the commitment expiration date. Nonrefundable loan origination fees that represent points, should be deferred and amortized over the life of the loan. Nonrefundable loan origination fees, other than points, should not be recorded until received in cash. All costs related to loan origination, acquisition and commitments should be charged to expense as incurred.

5.58 As noted in SSAP No. 37, paragraph 16, "A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. . . . . A reporting entity shall measure impairment based on the fair value (as determined by acceptable appraisal methodologies) of the collateral less estimated costs to obtain and sell. The difference between the net value of the collateral and the recorded investment in the mortgage loan shall be recognized as an impairment by creating a valuation allowance with a corresponding charge to unrealized loss or by adjusting an existing valuation allowance with a corresponding charge or credit to unrealized gain or loss. . . . Mortgage loans for which foreclosure is probable shall be considered permanently impaired." Nonrecoverable costs should be expensed in the period incurred. For mortgages that are in default, voluntarily conveyance, or foreclosure, the carrying value is adjusted for unpaid interest and additional expenses, such as legal fees to the extent they are expected to be recovered from the ultimate disposition of the property. Under SAP, troubled debt restructurings should be accounted for according to the type of the restructuring (transfer of assets in full settlement, grant of equity interest in full settlement, modification of terms or combination of types.) As noted in SSAP No. 36, *Troubled Debt Restructuring*, "Generally, troubled debt restructuring involving the transfer of assets or the grant of an equity interest shall be accounted for at the fair value of the assets transferred or the equity interest granted." Restructurings involving only modifications of terms are accounted for at fair value. If the restructuring is for a collateral dependent loan, the asset is written down to the fair value of the underlying collateral. If the loan is not collateral dependent, the fair value shall be determined in accordance with the Purposes and Procedures Manual of the NAIC Security Valuation Office, if applicable, or at the present value of expected future cash flows (see SSAP No. 36, paragraphs 10–12). A mortgage loan in which the title to the asset is being obtained shall be reclassified to real estate at the beginning of the redemption period unless it is probable that the loan will be redeemed.

5.59 Interest income on mortgage loans is recorded as earned, and contingent interest may be recorded as earned or as received. As noted in SSAP No. 37, paragraph 14, "If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the investment income shall continue to accrue, but all interest related to the loan is to be reported as a nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued."

5.60 SSAP No. 83 provides accounting and reporting guidance for mezzanine real estate loans (MRELs). Loans that meet the definition of a MREL are admitted assets and follow the accounting and reporting guidelines for mortgage loans contained within SSAP No. 37.

5.61 Under SAP, SSAP No. 40, *Real Estate Investments*, paragraph 4, "Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of the related encumbrances: *a*) Properties occupied by the company; *b*) Properties held for the production of income; and *c*) Properties held for sale." Properties occupied by the company and properties held for the production of income should be reported at depreciated cost. Properties held for sale should be reported at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. As noted in SSAP No. 40, paragraph 11, "The current fair value of real estate shall be determined on a property by property basis . . . and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale . . . If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon all relevant data about the market. . ." Appraisals are required to be no more than five years old, and a current appraisal should be obtained if there has been a significant decline in fair value. For real estate used in an entity's operations, the insurance entity is required to charge itself imputed rent, which is recorded as investment income and an operating expense in the Annual Statement.

5.62 SSAP No. 40, *Accounting for Impairment*, is based on FASB Statement No. 121* concepts. As noted in SSAP No. 40, paragraph 9, "If the fair value of the asset is less than the carrying value, the asset shall be written down to the fair value thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The adjustment shall be recorded in the statement of operations as a realized loss." SSAP No. 40 also adopts FASB Statement No. 66, *Accounting for Sales of Real Estate*, except for modification to the calculation of the buyer's initial investment as described in SSAP No. 40, paragraph 17.

5.63 Under SAP, SSAP No. 48, *Joint Ventures, Partnerships and Limited Liability Companies*, provides that these kinds of investments, except for limited partnerships with a minority interest, should be accounted for in accordance with the equity method. Investments in limited partnerships for which ownership is less than 10 percent, should be accounted for based on the audited GAAP equity. These kinds of investments should be reported in Other Invested Assets in the financial statements. Refer to discussion of SSAP No. 46 in paragraph 5.49 of this chapter.**

5.64 *Statutory Accounting Practices*. Under SAP, SSAP No. 33, *Securitization*,*** adopts portions of FASB Statement No. 125,*** with the following modifications as noted in paragraph 14 of the SSAP:

"*a.* This statement requires servicing rights assets to be nonadmitted;

b. This statement does not permit sales treatment for transactions where recourse provisions exist or where "call" or "put" options exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances;

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* FASB Statement 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, supersedes Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.* The NAIC has not yet adopted FASB Statement 144. The NAIC staff is currently working with the SAP Working Group to consider FASB No. 144 and its impact on SAP, including SSAP No. 40. Readers should be alert to any final pronouncement.

** Issue Paper No. 118, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46*, has been exposed for comment. Issue Paper No. 118 clarifies when either the statutory or GAAP equity basis should be used. If adopted as a SSAP, companies may need to change the valuation basis of their noninsurance and foreign insurance subsidiaries. Readers should be alert to any final pronouncement.

*** FASB Statement No. 140 replaces FASB Statement No. 125. The Statutory Accounting Principles Working Group is comparing statutory guidance to FASB Statement No. 140, which could result in modification to current SAP guidance.

c. This statement requires debtors to provide disclosure when a secured party is permitted to sell or pledge financial assets transferred as collateral whereas FASB Statement No. 125* requires the encumbered assets to be reported separately from unencumbered assets;

d. This statement does not address transfers of financial assets accomplished in a manner other than through securitization whereas FASB Statement No. 125* does address such transfers; and

e. Paragraph 14 is rejected as it is not applicable."

5.65 Under SAP, SSAP No. 18 and SSAP No. 45 set forth specific collateral requirements for securities lending, repurchase and reverse repurchase transactions. Collateral requirements are from 95% to 105% of the fair value or purchase price of the loan or transferred securities. The collateral requirement varies based upon the type of transaction (securities lending, repurchase, reverse repurchase) or denomination of the collateral. Additionally, SSAP No. 18, *Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,** adopts FASB Statement No. 125* for accounting for wash sales to permit sales recognition, but also requires expanded disclosures (see SSAP No. 18, paragraph 37 for a listing of information to be disclosed).

Special Risk Considerations

5.66 A key element to an effective audit is an understanding of the industry, operating environment, and accounting and internal control structure. Such understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

5.67 Property and liability insurance companies may incur increased underwriting losses as a consequence of their willingness to adopt a less restrictive underwriting philosophy to obtain more premium dollars to invest. This would be done as long as investment income exceeds expected underwriting losses by a sufficient margin, which is known as *cash flow underwriting*. However, as losses continue to increase and interest rates decline, it has been necessary to revise this strategy. Although underwriters have reacted by raising prices and tightening underwriting standards, greater investment performance is required to offset the increased underwriting losses. In addition to understanding this operating environment, the auditor should consider the following audit risks relating to the investment cycle that may affect carrying values, pricing, and permanent impairments:

- Investment concentration, by issuer, industry, or other
- Investment liquidity, such as investments with terms and maturities not matched with claims obligations
- Investment valuation, such as improper or inadequate valuation methods, documentation, or impairments that are other than temporary, and significant amounts of investments that are not readily marketable
- Investment yield trends (that is, the indicated ability to manage the investment portfolio at maximum yields commensurate with prudent risk considerations)

* FASB Statement No. 140 replaces FASB Statement No. 125. The Statutory Accounting Principles Working Group is comparing statutory guidance to FASB Statement No. 140, which could result in modification to current SAP guidance.

- Investment policy, such as emphasis on speculative or high-risk investments
- Investment restrictions (that is, degree of compliance with regulatory or self-imposed restrictions)
- Investment repurchase agreements, such as (*a*) the risk that the seller-borrower may not be able to complete the transaction and repurchase the security—credit risk, or (*b*) the risk that the collateral is not secure—particularly if it remains with the seller-borrower. (Guidance on such matters is provided by the AICPA's *Report of the Special Task Force on Audits of Repurchase Securities Transactions*.)

Chapter 6

Reinsurance

6.01 Insurance companies bring together people and entities subject to insurable hazards and collect from them premium amounts expected in the aggregate to be sufficient to pay all losses sustained by the insureds during the policy periods. From the insurer's perspective, the number of insureds must be large enough and diverse enough for the law of averages to operate. Frequently, however, an insurance company may be offered or may accept, for business reasons, insurance of a class or amount that does not permit the law of averages to operate or that could result in claims the insurer does not have the financial capacity to absorb. Such risks are spread among other insurance companies through reinsurance, which is the indemnification by one insurer of all or part of a risk originally undertaken by another insurer.

6.02 In addition to using reinsurance to spread the risk of its insurance contracts, an insurer may use reinsurance contracts to finance the growth of its business in terms of premiums written and loss reserve. In this regard, an insurance company's gross capacity (ability to write business) is limited by law or regulation based on the amount of its statutory surplus. The greater the ratio of premiums written or liabilities to such surplus, the less likely it is that the surplus will be sufficient to withstand adverse claim experience on business written. Through reinsurance contracts, an insurer can increase its ability to underwrite risks, thus effectively using reinsurance to facilitate the growth of its business.

6.03 The following are major reasons insurance companies enter into reinsurance contracts:

- To help balance their risks and capital
- To reduce their exposure on particular risks or classes of risks
- To protect against accumulations of losses arising out of catastrophes
- To reduce total liabilities to a level appropriate to their capital
- To provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted
- To help stabilize operating results
- To obtain assistance with new products and lines of insurance
- To limit liabilities of captive insurance companies, created for the purpose of supplying insurance to noninsurance companies, to a level considered acceptable by the parent companies

For similar reasons, reinsurers also may transfer a portion of their assumed risks to other insurance and reinsurance companies, a practice known as *retrocession*.

Types of Reinsurance

6.04 Reinsurance transactions are between insurance entities, the ceding entity remains primarily liable to the policyholder. In addition, the ceding entity bears the risks that the reinsurer may be unable to meet its obligations for the risks assumed under the reinsurance agreement. The policyholder is generally not aware of any indemnity reinsurance transactions that may occur and continues to hold the original contract.

6.05 *Assumption reinsurance* agreements are legal replacements of one insurer by another and thereby extinguish the ceding enterprise's liability to the policyholder.

6.06 *Fronting* is an arrangement between two or more insurers whereby the fronting entity will issue contracts and then cede all or substantially all of the risk through a reinsurance agreement to the other insurer(s) for a ceding commission. Such arrangements may be illegal if the intent is to circumvent regulatory requirements. (SAS No. 54, *Illegal Acts by Clients*, addresses the auditor's responsibility for detection of illegal acts.) As with other indemnity reinsurance agreements, the fronting entity remains primarily liable to the policyholder.

6.07 In the United States there are basically three kinds of reinsurance entities: (*a*) *professional reinsurers*, which engage almost exclusively in reinsurance, although they are usually permitted by their charters and licenses to operate as primary insurance companies; (*b*) *reinsurance departments of primary insurance companies*, which function as units of primary insurers and engage in reinsurance; (*c*) groups or syndicates of insurers referred to as *reinsurance pools or associations*, which may be organized to provide their members with reinsurance protection and management for certain specialized, high-risk coverage or with general access to the reinsurance market for traditional lines of business. In addition, reinsurance intermediaries, including brokers, agents, managing general agents, and similar entities, facilitate reinsurance by bringing together ceding companies and reinsurers. Reinsurance intermediaries may underwrite, design, and negotiate the terms of reinsurance. They usually place reinsurance, accumulate and report transactions, distribute premiums, and collect and settle claims.

6.08 In addition to providing for a basic ceding commission, intended to reimburse the ceding insurer for the cost of underwriting the business, reinsurance contracts may also provide for contingent commissions or retrospectively rated premiums, which are intended to allow the ceding insurer to share in the profits or losses realized by the assuming reinsurer on the business subject to the contract. Reinsurance contracts additionally may provide for sliding scale commissions, or commission adjustments under a formula that allows increasing commissions as losses decrease and vice versa, subject to maximum and minimum limits. Contract provisions such as these may affect the risk transfer characteristics that determine how reinsurance contracts are accounted for.

Kinds of Reinsurance Contracts

6.09 Flexibility is one of the characteristics of the reinsurance business. Reinsurance contracts are usually negotiated individually and in practice no two contracts are exactly alike. Contracts are occasionally encountered that cannot be readily classified. However, the principal kinds of reinsurance are pro rata reinsurance and excess reinsurance.

6.10 *Pro rata reinsurance.* Pro rata reinsurance is a sharing, on a predetermined basis, by the insurer and the reinsurer of premiums and losses on a risk, class of risks, or particular portion of the insurer's business. In consideration of a predetermined portion of the insurer's premium or premiums, the reinsurer agrees to pay a similar portion of claims and claim-adjustment expenses incurred on the business reinsured. The reinsurer's participation in the claims is set without regard to the actual frequency and severity of claims. Pro rata reinsurance can be effected by means of quota share or surplus share reinsurance.

6.11 *Quota share reinsurance.* Quota share reinsurance is a kind of pro rata reinsurance in which the ceding company cedes a proportional part (a percentage) of risks to the reinsurer, and in turn will recover from the reinsurer the same percentage of all losses on those risks. For example, under a 50-percent-quota-share treaty the reinsurer receives 50 percent of the insurer's premiums, less ceding commissions, and is obligated to pay 50 percent of each claim as well as the claim-adjustment expense incurred by the insurer. Such reinsurance is frequently used for new lines or by new companies; for example, a company just entering the casualty field may arrange for quota share reinsurance only for its casualty business.

6.12 *Surplus share reinsurance.* Surplus share reinsurance is insurance that reinsures on a pro rata basis only those risks on which the coverage exceeds a stated amount. Under a surplus treaty, an insurer might reinsure what it considers to be surplus exposure under each large dwelling policy that it writes. For example, the insurer might reinsure the amount of each dwelling policy above $25,000; the insurer would reinsure $15,000 on a dwelling policy for $40,000. Premiums and losses are shared by the reinsurer and the insurer on a pro-rata basis in proportion to the amount of risk insured or reinsured by each. The reinsurer would not participate at all in any losses incurred on policies with limits of $25,000 or less.

6.13 *Excess reinsurance.* Under excess reinsurance, the insurer limits its liability to all or a particular portion of the amount in excess of a predetermined deductible or retention. Thus, the reinsurer's portion of the loss depends on the size of the loss. The relationship between the premium and claims of the insurer and the reinsurer is not proportional. Excess reinsurance takes three basic forms: per risk basis, per occurrence basis, and aggregate basis.

6.14 *Excess of loss per risk reinsurance.* Excess of loss per risk reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on each risk covered under the reinsurance, such as all fire policies written. The reinsurer reimburses the insured for the portion of any claim in excess of the insurer's retention, subject to the limit stated in the reinsurance agreement.

6.15 *Excess of loss per occurrence reinsurance.* Excess of loss per occurrence reinsurance requires the insurer to pay all claims up to a stated amount or retention limit on all losses arising from a single occurrence. The reinsurer pays claims in excess of the limits. One purpose of obtaining per occurrence excess reinsurance is to protect a company from the accumulation of losses arising from earthquakes, tornadoes, or similar occurrences. Such reinsurance is also referred to as *catastrophe reinsurance*.

6.16 *Aggregate excess of loss reinsurance.* Aggregate excess of loss reinsurance requires the insurer to pay all claims during a specified period up to a predetermined limit for the period on all its business or any definable portion of the claim. This is usually expressed as a loss ratio (for example, reinsurance against losses that would cause a company's loss ratio to exceed 75 percent). Such reinsurance is also referred to as *stop loss reinsurance*.

Bases of Reinsurance Transactions

6.17 Reinsurance is transacted either on a facultative or a treaty basis. Under *facultative reinsurance*, each risk or portion of a risk is reinsured individually, and the assuming company has the option to accept or reject each risk. Risks are separately underwritten by the assuming company in much the same manner as if a direct policy were being issued. The assuming company therefore has all of the policy information necessary to maintain all of the accounting records, including gross premiums and reinsurance premiums, term of the policy, reinsurance commissions, and individual claims data. Because the assuming company must specifically obligate itself before assuming the risk, the company is aware of all of the risks assumed at any point. The assuming company maintains complete records about all facultative business assumed and, therefore, has information needed to account for premiums written and receivable, commissions incurred and payable, and losses and expenses incurred and payable.

6.18 Under *treaty-basis reinsurance*, any agreed portion of business written is automatically reinsured, thereby eliminating the need for the assuming company to accept or reject each risk. Because of the time lag in reporting by the ceding company, the assuming company is likely to be unaware of some of the risks it has assumed at a particular point. The reports received by the assuming company from the ceding company may be complete *bordereaus* (or listings) of pertinent information on each risk or summaries of risks.

6.19 If the ceding company reports only summarized information, the assuming company may not have complete information relating to reinsurance activities. For example, without knowing the reinsurance premiums by policy term, the assuming company cannot directly calculate its unearned premium reserve; but must use amounts reported by the ceding company. The assuming company, which has no direct relationship with the insured, must also depend on the ceding company to report the reinsured portion of reported claims and, in some quota-share-treaty accounts, the estimated liability for IBNR claims. Despite the lack of detailed information, the assuming company is responsible for properly accounting for the transaction.

6.20 Reinsurance may be transacted and serviced directly between the ceding and assuming companies or through reinsurance intermediaries, brokers, agents, or managing general agents. Reporting of information to the assuming company is negotiated as part of a reinsurance transaction involving an intermediary or broker.

Accounting Practices

6.21 FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, specifies the accounting by insurance enterprises for the reinsurance (ceding) of insurance contracts. SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, provides guidance for accounting for reinsurance contracts that do not transfer insurance risk. Further, the FASB published an article *Accounting for Reinsurance: Questions and Answers about Statement 113*, in the February 26, 1993 issue of *FASB Viewpoints* containing 42 implementation questions and answers. The article is also included in Appendix D (Topic D-34) of the FASB's EITF Abstracts.

6.22 *Conditions for Qualifying for Reinsurance Accounting.* In general, FASB Statement No. 113 requires a determination of whether or not a reinsurance agreement, despite its form, qualifies for reinsurance accounting. To qualify, a reinsurance contract should indemnify the ceding enterprise from loss or liability relating to insurance risk. Paragraph 8 of FASB Statement No. 113 addresses determining whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk. Paragraphs 9 to 11 of FASB Statement No. 113 address criteria for short-term contracts to be accounted for as reinsurance. Paragraphs 12 and 13 of FASB Statement No. 113 address criteria for long-duration contracts to be accounted for as reinsurance.

6.23 In Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, the FASB's EITF discussed and reached consensuses on several issues relating to accounting by insurers (ceding enterprises) for multiple-year retrospectively rated reinsurance contracts (RRCs) with reinsurers (assuming enterprises). Examples of these contracts may include transactions referred to as "funded catastrophe covers." Users of this guide should refer to those issues and the related consensuses in the FASB's EITF Abstracts.

Reporting Assets and Liabilities

6.24 *Assumption reinsurance.* These reinsurance agreements are legal replacements of one insurer by another and thereby extinguish the ceding enterprise's liability to the policyholder and should be accounted for by removing the related assets and liabilities from the financial statements of the ceding entity. Assumption reinsurance transactions may result in an immediate recognition of a gain or loss.

6.25 *Other reinsurance agreements.* Reinsurance agreements for which the ceding entity remains primarily liable to the contract holders would not result in the removal of the related assets and liabilities from the ceding entities' records. For these agreements, the ceding entity should report as assets, estimated reinsurance receivables and any prepaid reinsurance premiums arising from those agreements. Amounts receivable from and payable to an assuming entity should be offset only when a right of offset exists, as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts.*

6.26 Reinsurance receivables and prepaid reinsurance premiums should be recognized in a manner consistent with the related liabilities (estimates for claims incurred but not reported and future policy benefits) relating to the underlying insurance contracts. Assumptions used in estimating reinsurance receivables should be consistent with those assumptions used in estimating the related liabilities. As in all reinsurance contracts, the ceding entity should evaluate the financial soundness and the collectibility of reinsurance receivables, to make a determination that the reinsurer has the ability to honor its commitment under the contract.

6.27 The amounts of premiums ceded and recoveries under reinsurance agreements may be reported in the income statements as a separate line item, noted parenthetically on the face of the income statement, or disclosed in the footnotes to the financial statements.

Reporting Revenues and Costs

6.28 Paragraphs 21 through 25 of FASB Statement No. 113 provide guidance on recognition of revenues and costs for reinsurance of short-duration contracts. Paragraph 26 of FASB Statement No. 113 provides guidance on recognition of revenues and costs for reinsurance of long-duration contracts.

Reinsurance Agreements Not Qualifying for Reinsurance Accounting Under FASB Statement No. 113 or EITF 93-6

6.29 FASB Statement No. 113 does not specifically address accounting for reinsurance agreements that do not meet the conditions for reinsurance accounting, other than to incorporate the provisions from FASB Statement No. 60, paragraphs 39 and 40 which continue in effect and are included in paragraph 18 of FASB Statement No. 113 as follows:

a. To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

b. Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized.[1] If the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability shall be accrued for estimated excess future servicing costs under the reinsurance contract. The net cost to the assuming enterprise shall be accounted for as an acquisition cost.

6.30 SOP 98-7 provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. The transfer of insurance risk requires transferring both timing risk and underwriting risk. SOP 98-7 applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to as *deposit accounting*. SOP 98-7 neither addresses when deposit accounting should be applied, nor provides criteria to make that determination. Such guidance is provided on a case-by-case basis in the applicable pronouncements. Paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, FASB Statement No. 113, EITF Issue No. 93-6, and EITF Issue No. 93-14 provide guidance on when deposit accounting should be applied to insurance and reinsurance contracts.

6.31 Paragraph 9 of SOP 98-7 requires that at inception, a deposit asset or liability be recognized for insurance or reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit asset and liabilities should be reported on a gross basis, unless the right of setoff exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

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[1] Paragraph 29 of FASB Statement No. 60 addresses recognition of acquisition costs.

6.32 Paragraphs 10 through 17 of SOP 98-7 provide guidance about the measurement of the deposit asset or liability at subsequent reporting dates. The subsequent measurement of the deposits is based upon whether the insurance and reinsurance contract (1) transfers only significant timing risk, (2) transfers only significant underwriting risk, (3) transfers neither significant timing nor underwriting risk, or (4) has indeterminate risk.

6.33 Paragraphs 18 and 19 of SOP 98-7 require the following disclosures:

a. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

b. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

   (1) The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses.

   (2) Any adjustments of amounts initially recognized for expected recoveries. (The individual components of the adjustment [i.e., interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries] should be disclosed separately.)

   (3) The amortization expense attributable to the expiration of coverage provided under the contract.

6.34 *Experience-rated refunds.* Some reinsurance agreements provide for experience-rated refunds, which allows the ceding entity to participate in the profits of the reinsured business. In general, experience refunds are determined by the assuming entity by deducting from premiums assumed claims or losses incurred and a predetermined reinsurance profit (expense and profit charge). Most experience-rated reinsurance agreements will have stated terms for calculation formulas and other factors to be included.

Disclosures

6.35 Paragraphs 27 and 28 of FASB Statement No. 113, as amended by FASB Statement No. 133, prescribe information that should be disclosed regarding reinsurance activities. Paragraphs 18 and 19 of SOP 98-7 require disclosures about contracts that do not transfer insurance risk.

Statutory Accounting Practices

6.36 Under statutory accounting practices, as under generally accepted accounting principles, the essential ingredient of a reinsurance contract is the indemnification of risk. A number of states regulate reinsurance arrangements by disallowing the recognition of increased surplus resulting from non-risk-shifting arrangements. In general, the accounting treatment by ceding companies for reinsurance transactions is opposite from that of transactions that arise from writing direct business, and the amounts of the reinsurance transactions are netted against the direct amounts for financial statement presentation (for example, the premium accounts are netted against the direct amounts for premiums related to insurance ceded). The assuming company's accounting for reinsurance normally parallels the original accounting for direct business. Refer to SSAP No. 62, *Property and Casualty Reinsurance*, for additional guidance on property and casualty reinsurance.

6.37 The terms *unauthorized reinsurer* and *nonadmitted reinsurer* refer to a reinsurer not authorized or licensed to do business in the state in which the ceding company is domiciled. Licensed companies can write direct business in the state; if licensed, a company is also authorized to assume reinsurance in that state. A nonlicensed company can assume reinsurance if the state authorizes it to do so, and it is then considered to be an authorized reinsurer. In statutory financial statements, the ceding company cannot obtain surplus credit for unearned premiums ceded to and losses recoverable from an unauthorized reinsurer unless collateralized by assets held, a letter of credit, or other forms of qualifying collateral. A ceding company must establish a liability for unauthorized reinsurance in an amount equal to the excess of the reserve credits taken over the funds held or letter of credit for the business ceded.

Special Risk Considerations

6.38 Reinsurance contracts can be complex documents. A ceding company does not discharge its obligations to the insureds through reinsurance but only obtains the right to reimbursement from the assuming company. Therefore, the ceding company faces the risk that the assuming company may not have the financial capacity or stability to meet its obligations when they are due. An absence of an adequate reinsurance program may expose an insurance company (the ceding company) to substantial risks in relation to the company's financial position, particularly if the company's risks are concentrated geographically or by kind of risk. Also, a lack of sufficient experience to manage and underwrite assumed reinsurance may expose the assuming company to substantial risks in relation to the company's financial position. Therefore, the auditor should be aware that reinsurance programs may indicate (but do not necessarily confirm) the existence of increased audit risk.

6.39 The assumption of reinsurance requires special consideration of the accuracy and reliability of the data received from the ceding company, either directly or through a reinsurance intermediary. The extent of the detail in the information provided to the assuming company by the ceding company or the reinsurance intermediary can vary significantly in—

- Timeliness of the information submitted.
- Detail of information relating to policies, claims, unearned premiums, and loss reserves.
- Annual statement line-of-business classification.
- Foreign currency translation information on business assumed from companies domiciled in foreign countries (alien companies).

6.40 Information on IBNR claims and bulk reserves also may be reported by ceding companies under pro rata reinsurance arrangements. Generally, no IBNR is reported on nonproportional—that is, excess-reinsurance—arrangements. Based on the quality and comprehensiveness of the information received from the ceding company, the information provided may or may not be used by the assuming company.

Internal Control of the Ceding Company

6.41 The auditor of a ceding company should obtain an understanding of the entity's procedures for (*a*) evaluating the financial responsibility and stability of the assuming company, whether the assuming company is domiciled in the United States or in a foreign country, and (*b*) providing reasonable assurance about the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company's control activities to evaluate the financial responsibility and stability of the assuming company may include—

- Obtaining and analyzing recent financial information of the assuming company, such as—
  - Financial statements and, if audited, the independent auditor's report.
  - Financial reports filed with the SEC (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
  - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development and the quality and liquidity of the company's invested assets.
- Obtaining and reviewing available sources of information relating to the assuming company, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Loss reserve certifications filed with regulatory authorities.
  - Letters relating to the design and operation of controls filed with regulatory authorities.
  - IRIS and RBC results filed with regulatory authorities.
- Inquiring about the assuming company's retrocessional practices and experience.
- Inquiring about the general business reputation of the assuming company and the background of its owners and management.
- Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or, if not, whether letters of credit or other means of security are provided.
- Considering the need for and evaluating the adequacy of collateral from the assuming company on collateralized reinsurance contracts.

6.42 The ceding company's control activities relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control activities for the direct recording of direct insurance transactions. (Those control activities are described in appendix B.)

Control Environment

6.43 The control environment as related to reinsurance transactions of a property and liability insurance company represents the collective effect of various factors on the effectiveness of specific control activities of the entity. The auditor should consider such factors influencing inherent risk related to reinsurance assumed and ceded, including factors relating to management, product characteristics, underwriting approach, marketing strategies, financial objectives, and the economic and regulatory environment. Such factors might include the following:

- The property and liability insurance company uses complex reinsurance transactions at or near the end of the period to achieve financial performance goals or improve its surplus position.
- The property and liability insurance company is involved in a significant amount of international reinsurance, or reinsurers are in jurisdictions with foreign exchange controls.
- There are no executed contractual agreements between the ceding entity and the reinsurer.
- Reinsurance coverage is inadequate (it does not meet the business need or does not reflect management's intended reinsurance program).
- The ceding entity's reinsurers are in financial difficulty.
- Reinsurance has become unavailable at the property and liability insurance company's desired retention levels and costs.
- There are significant or unexpected changes in the entity's reinsurance programs.
- The reinsurance agreement does not transfer adequate economic risk where this was the intention of the parties.
- Risk assumed under treaty arrangements is excessive.
- Financial information received is inadequate, or not received on a timely basis.
- Regulations may not permit the treatment of certain reinsurance agreements as reinsurance.
- Significant reinsurance agreements involve wholly owned subsidiaries or other related parties.

Control Activities

6.44 Control activities are those policies and procedures that help ensure that management directives are carried out and that necessary actions are taken to address risks to achieve the entity's objectives. In addition to control activities, discussed in paragraph 6.43, relating to the evaluation of the control activities of the reinsurer, the following are examples of typical controls relating to reinsurance transactions:

- *Proper authorization of transactions and activities.* Written guidelines for reinsurance transactions are in place assigning appropriate responsibility for approval.
- *Segregation of duties.* Reinsurance transactions, claims processing, premium collection, key information systems functions, and general accounting activities should be appropriately segregated, and independent reviews should be conducted of the work performed.
- *Design of adequate control over documents and records.* There are procedures to ensure that fictitious or duplicate reinsurance transactions are not included in the records and to prevent or detect the omission of valid transactions.
- *Adequate safeguards of access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access; and adequate safeguards exist over access to any collateral from the assuming entity that may be held by the ceding entity.
- *Independent checks on performance and proper valuation of recorded amounts.* Recorded insurance transactions are subject to independent testing or other quality control checks; reinsurance ceded transactions are periodically confirmed directly with the reinsurer; reviews

are performed to determine that reinsurance transactions are valid and supported by appropriate documentation as required by the reinsurance agreement; and independent evaluations are performed on the adequacy of any collateral held from assuming entities on reinsurance agreements.

Accounting Systems

6.45 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.

6.46 The transaction flow of accounting records for reinsurance transactions usually encompasses all functions relating to underwriting, premium collection, commission processing, and claims payments.

Internal Control of the Assuming Company

6.47 A significant component of an assuming company's internal control that is related to assumed reinsurance is the assessment of the accuracy and reliability of data received from the ceding companies. Principal control activities of the assuming company may include—

- Maintaining underwriting files with information relating to the business reasons for entering the reinsurance contracts and anticipated results of the contracts. The underwriting files may include—
  - — Historical loss ratios and combined ratios of the ceding companies.
  - — Anticipated loss ratios under the contracts.
  - — Indications of the frequency and content of reports for the ceding companies.
  - — Prior business experience with the ceding companies.
  - — The assuming company's experience on similar risks.
  - — Information regarding pricing and ceding commissions.
- Monitoring the actual results reported by the ceding companies and investigating the reasons for and the effects of significant deviations from anticipated results.
- Visiting the ceding companies to review and to evaluate their underwriting, claims processing, loss reserving, and loss-reserve-development-monitoring procedures.
- Obtaining the report of the ceding companies' independent accountants on controls (relating to ceding reinsurance) placed in operation (and tests of operating effectiveness). See SAS No. 70, *Service Organizations*.*

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* The Auditing Standards Board (ASB) issued during the first half of 2002 a new Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*. The Guide includes illustrative control objectives as well as three new interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

6.48 Additional control activities of the assuming company may include—

- Obtaining and analyzing recent financial information of the ceding companies, such as—
  - Financial statements and, if audited, the independent auditor's report.
  - Financial reports filed with the SEC (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
  - Financial statements filed with insurance regulatory authorities, with particular attention to loss reserve development.
- Obtaining and reviewing available sources of information on the ceding companies, such as—
  - Insurance industry reporting and rating services.
  - Insurance department examination reports.
  - Loss reserve certifications filed with regulatory authorities.
  - Letters relating to the design and operation of controls filed with regulatory authorities.
- Inquiries about the general business reputation of the ceding companies and the background of their owners and managements.

Auditing Procedures for the Ceding Company

6.49 The independent auditor also should be aware of reinsurance issues that are discussed in the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce's report, *Failed Promises: Insurance Company Insolvencies* (issued February/1990).[2]

6.50 The ceding company's independent auditor should obtain an understanding of the ceding company's ability to honor its commitments under the reinsurance contract. Chapter 4 of this guide discusses how the auditor assesses control risk. If the auditor intends to rely on the prescribed procedures, the auditor should perform tests of the ceding entity's procedures to obtain reasonable assurance that they are in use and operating as planned.

6.51 The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the failure to apply adequately designed procedures as planned, may constitute a reportable condition in the ceding company's internal control. SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, discusses the auditor's responsibility for communication of a significant deficiency in internal control to the audit committee. Based on his or her assessment of control risk, the auditor should consider performing substantive tests sufficient to evaluate the collectibility of amounts reported in the financial statements as recoverable from the assuming company. The auditor's tests may include certain of the procedures specified above but they are not necessarily limited to those procedures.

6.52 To obtain reasonable assurance whether reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company should consider performing procedures for selected contracts, selected transactions, and related balances, including—

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[2] This paragraph also applies to the assuming company's independent auditor (refer to paragraph 6.53) and to the auditor of reinsurance intermediaries (refer to paragraph 6.38).

- Reading the reinsurance contract and related correspondence to—
  - — Obtain an understanding of the business objective of the reinsurance contract.
  - — Determine whether the contract indemnifies the ceding company against loss or liability, and meets the conditions for reinsurance accounting or whether it should be accounted for under deposit accounting, as defined in SOP 98-7.
- Tracing entries arising from selected reinsurance contracts to the appropriate records.
- Tracing the selected transactions to supporting documents and testing the related receivables and payables.
- Obtaining written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Auditing Procedures for the Assuming Company

6.53 An assuming company's independent auditor should obtain an understanding of the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding companies. If the auditor intends to assess control risk as being less than maximum, he or she should evaluate the suitability of the assuming company's procedures for his or her purposes and test the procedures to obtain evidence that they are in use and operating as prescribed.[3]

6.54 The absence of adequate procedures by the assuming company to provide assurance regarding the accuracy and reliability of data received from the ceding company, or not applying adequately designed procedures that are in use and operating as prescribed, may constitute a reportable condition in the assuming company's internal control. Based on his or her assessment of control risk, the auditor should perform substantive tests sufficient to obtain assurance regarding the accuracy and reliability of the data received from the ceding companies. The auditor's substantive procedures may include, but would not necessarily be limited to, one or more of the following:

- Performing certain of the procedures described as control activities in paragraph 6.48
- Meeting and review the work of the ceding companies' independent auditors (see SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*)
- Performing auditing procedures at the ceding companies or requesting their independent auditors to perform agreed-upon procedures
- Obtaining reports from the ceding companies' independent auditors on the ceding companies' internal control relating to ceded reinsurance (see SAS No. 70, *Service Organizations*)[*]

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[3] Refer to "Auditing Procedures for the Ceding Company" in paragraphs 6.49 through 6.52.

[*] The Auditing Standards Board (ASB) issued during the first half of 2002 a new Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*. The Guide includes illustrative control objectives as well as three new interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

6.55 The auditor's inability to perform the procedures considered necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify the opinion or disclaim an opinion (see SAS No. 58). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the audit report.

6.56 To determine whether reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company should consider performing procedures for selected contracts, selected transactions, and related balances, including—

- Reading the reinsurance contract and related correspondence to—
  - Obtain an understanding of the business objective of the reinsurance contract.
  - Determine whether the contract should be accounted for as reinsurance or deposit
- Tracing entries arising from selected reinsurance contracts to the appropriate records.
- Tracing the selected transactions to supporting documents and testing the related receivables and payables.
- Obtaining written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Pools, Associations, and Syndicates

6.57 Participation in reinsurance pools, associations, and syndicates is in some respects similar to reinsurance, and the guidance in paragraphs 6.49 to 6.56 generally applies to audits of participating companies. Pools, associations, and syndicates often issue audited financial statements to participating companies, and auditors of participating companies may use the report of the independent auditor of the pool, association, or syndicate in their audits. SAS No. 1, section 543 provides guidance for such use.

Reinsurance Intermediaries

6.58 Reinsurance intermediaries' involvement may include evaluation, underwriting, negotiations, and fund transfers. The assuming and ceding companies should coordinate their control activities with those of the intermediaries.

6.59 A company may delegate to a reinsurance intermediary the performance of the procedures described in the sections "Internal Control of the Ceding Company," paragraphs 6.41 to 6.46 and "Internal Control of the Assuming Company," paragraphs 6.47 and 6.48. The company, however, should have procedures to satisfy itself that the reinsurance intermediary is adequately performing those procedures. The guidance provided to the independent auditor in those sections may be applied.

6.60 In addition to the functions discussed in the previous paragraphs, a reinsurance intermediary may be authorized to collect, hold, disburse, or remit funds on behalf of an insurance company. The insurance company should have controls to provide reasonable assurance that the reinsurance intermediary is adequately performing those functions; safeguarding the funds and, if required, appropriately segregating them; and settling accounts on a timely basis. The insurance company may accomplish this by obtaining a special report from the independent auditor of the reinsurance intermediary or by visiting the reinsurance intermediary and reviewing its controls that relate to those functions. The auditor of the insurance company should assess control risk in this area as described in chapter 4 of this guide.

6.61 The auditor should read the intermediary clauses in an assuming company's reinsurance contracts.[4] Such clauses, which identify the specific intermediaries or brokers involved in negotiating the contracts, communicating information, and transmitting funds, should state clearly whether payment to the intermediaries constitutes payment to the other parties to the reinsurance contracts. An example of such a clause, under which the reinsurer assumes the credit risks in the transmission of reinsurance funds, follows:

> _____ is hereby recognized as the Intermediary negotiating this contract. All communications (including but not limited to notices, statements, premiums, return premiums, commissions, taxes, losses, loss adjustment expenses, salvages, and loss settlements) relating thereto shall be transmitted to the ceding company or the reinsurers through _______________. Payments by the ceding company to the Intermediary shall be deemed to constitute payment to the reinsurers. Payments by the reinsurers to the Intermediary shall be deemed to constitute payment to the ceding company only to the extent that such payments are actually received by the ceding company.

Accounting for Foreign Property and Liability Reinsurance

6.62 The promulgation of rules and regulations by state insurance departments and the adoption of specialized insurance industry accounting standards by the FASB have resulted in considerable uniformity in accounting practices in the insurance industry in the United States. Outside the United States, insurance accounting and reporting practices vary widely. The diversity in insurance accounting and reporting practices of foreign insurance companies has led to questions on how U.S. insurance companies should account for property and liability reinsurance assumed from foreign companies (foreign reinsurance).

6.63 Reinsurers assuming business from domestic companies have historically had sufficient information to monitor and account for contract results. In contrast, some reinsurers assuming business from foreign companies do not receive such information, because in some foreign jurisdictions, insurance companies' accounting and reporting practices concerning periodic recognition of revenue and incurred claims are substantially different from U.S. practices. Therefore, reinsurers assuming business from foreign ceding companies cannot always obtain sufficient information to periodically estimate earned premiums for the business assumed from the foreign ceding companies.

6.64 A significant amount of reinsurance is transacted through syndicates organized by Lloyd's of London. Lloyd's syndicates report the amounts of premiums, claims, and expenses recorded in an under-writing account for a particular year to the assuming companies that participate in the syndicates. The syndicates generally keep accounts open for three years. Traditionally, three years have been necessary to report substantially all premiums associated with an underwriting year and to report most related claims, although claims may remain unsettled after the account is closed. A Lloyd's syndicate

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[4] Refer to "Auditing Procedures for the Ceding Company" in paragraphs 6.49 through 6.52.

typically closes an underwriting account by reinsuring outstanding claims on that account with a syndicate for the next underwriting year. The ceding syndicate pays the assuming syndicate an amount based on the unearned premiums and outstanding claims in the underwriting account at the date of the assumption and distributes the remaining balance to its participants.

Current Practices

6.65 Three methods are currently used in the United States to account for foreign property and liability reinsurance: the periodic method, the zero balance method, and the open year method.

Periodic Method

6.66 The periodic method of accounting for reinsurance provides for current recognition of profits and losses. It is used when ultimate premiums and the period of recognition can be reasonably estimated currently. Premiums are recognized as revenue over the policy term, and claims, including an estimate of claims incurred but not reported, are recognized as they occur. The periodic method is consistent with current practice for primary insurance and domestic reinsurance for which sufficient information is available to reasonably estimate and recognize earned premiums and related claims. (Refer to FASB Statement No. 60.)

6.67 Some foreign ceding companies maintain the information necessary to estimate earned premiums, incurred claims, and related expenses currently. As a result, U.S. reinsurers doing business with these foreign ceding companies are able to account for reinsurance assumed by applying the same periodic method of accounting that they use to account for domestic reinsurance. Although not all foreign ceding companies maintain and report current information necessary to estimate earned premiums, incurred claims, and related expenses, some U.S. reinsurers have sufficient experience with the foreign business assumed to estimate earned premiums. When earned premiums can be estimated, sufficient information usually exists to estimate incurred claims and related expenses. Anticipated results based on either the reinsurer's experience or reported data make it possible to reasonably estimate underwriting results and use the periodic method.

Zero Balance Method

6.68 Many foreign ceding companies do not maintain the information necessary to estimate earned premiums. As a result, U.S. reinsurers doing business with these foreign companies generally are not able to apply the periodic method of accounting. Some of these companies use the zero balance method, which is a modified cash basis of accounting. This method is similar to the cost recovery method described in FASB Statement No. 60, paragraph 14. Because of the inherent lag in reporting claims, profits reported by foreign ceding companies in early years often exceed the total profits that will ultimately be realized. To avoid reporting overstated profits, companies using this method adjust the records with arbitrary provisions for claims incurred in amounts that exactly offset the cash basis profits.

Open Year Method

6.69 Under the open year method, underwriting results of foreign reinsurance are not included in the income statement until sufficient information becomes available to provide reasonable estimates of earned premiums. The open year method is similar to the deposit method as described in SOP 98-7.

Because the measurement period extends over more than one accounting period, premiums, claims, and expenses are not immediately included in operating results. Instead, they are accumulated and reported in the balance sheet as an open underwriting balance. The underwriting balance is disaggregated and reported in the income statement as premiums, claims, and expenses only when earned premiums become reasonably determinable. If it is probable that a loss has been incurred before an underwriting balance is closed, a provision for a loss generally is recorded. Examples of situations in which a provision may be recorded before an underwriting balance is closed include catastrophic losses, higher-than-expected claim frequency, significant unanticipated adverse events, or a negative open year account. The accounting treatment is similar to that for premium deficiencies described in FASB Statement No. 60, paragraph 32.

Comparison With Practices in Other Industries

6.70 Deferral of revenue occurs in industries that sell goods subject to rights of return. If a right of return exists, current recognition of a sale is not permitted unless the amount of future returns is reasonably estimable. If that amount is not reasonably estimable, recognition of income is postponed until the return privilege has substantially expired. Income recognition is also postponed for certain real estate sales through the use of the installment and cost recovery methods. Those methods are analogous to the open year method.

6.71 Methods that defer recognition of underwriting profits raise financial accounting issues concerning (*a*) whether premiums and claims should be reported as income currently, even though the related underwriting balance[5] is deferred, and (*b*) whether the underwriting balance should be recorded as deferred income or as an addition to claim liabilities. Most companies that follow the zero balance method record premium and claim amounts currently and defer recognition of profits by additions to claim liabilities. Although this presentation provides timely information on the volume of business being conducted by the enterprise, the usefulness of the information is limited because the related profit margins are not also reported.

6.72 Current accounting literature supports alternative methods of financial presentation when profit recognition is deferred. For example, recognition as income of both revenues and related costs is deferred under the completed contract method until the contract is substantially completed. However, if either the installment method or cost recovery method is used to defer the recognition of gain on the sale of real estate, the sale and related costs are ordinarily reported on the date of the transaction. The deferred profit is reported separately in the income statement as a deduction from sales in the year the transaction occurs and as a separate item of revenue in future years' income statements, when the profit is recognized.

6.73 Proponents of presenting premiums, claims, and expenses in the income statement when the amounts are reported to the reinsurer point out that excluding those amounts from the income statement until an underwriting year is closed does not reflect the economic substance of current period activities under the reinsurance contract. In response to criticism that presentation of the amounts in the income statement may cause profit margins to be misstated, they argue that disclosure of profits deferred and profits recognized provides sufficient information for users to evaluate operating results.

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[5] The term *underwriting balance* refers to the excess of reported premiums over reported claims and expenses. This amount is not intended to represent income realized on a contract.

6.74 Proponents of reporting deferred amounts in the balance sheet until the profits relating to the underwriting year are recognized point out that the income statement should reflect profit margins associated with the premium volume reported in the income statement, and that this can best be done by recognizing the related premiums in the periods the profits are recognized. They acknowledge that premiums, claims,, and expenses associated with a contract in a period may be important information to users, but they argue that the information could be disclosed in the notes to the financial statements or in the statement of cash flows to avoid misstating the profit margins.

6.75 The periodic method should be used to account for foreign reinsurance except in the circumstance described in paragraph 6.76.

6.76 If, due to local revenue recognition policies, the foreign ceding company cannot provide the information required by the assuming company to estimate both the ultimate premiums and the appropriate periods of recognition in accordance with accounting principles generally accepted in the United States of America, then the open year method should be used.[6] The presence of uncertainties that may be inherent in estimating earned premiums is not an acceptable basis for using the open year method. As discussed in paragraph 6.69, premiums, claims, commissions, and related direct taxes should not be reported currently as income under the open year method; instead, they should be included in the open underwriting balance to which they pertain. The underwriting balances should be aggregated and included in the balance sheet as a liability. Each underwriting balance should be kept open until sufficient information becomes available to record a reasonable estimate of earned premiums. The underwriting balance should be disaggregated and reported in the income statement as premiums, claims, commissions, and related direct taxes when earned premiums are reasonably determinable.

6.77 If it becomes probable that a loss has been incurred before an underwriting balance is closed, a provision for the loss should be recorded.

6.78 The periodic and open year methods are not interchangeable in the same circumstances. The periodic method should be used to account for foreign reinsurance. Only if reasonable estimates cannot be made currently, for the reason discussed in paragraph 6.76, should the open year method be used. The periodic and open year methods are not alternative accounting principles as discussed in APB Opinion No. 20, *Accounting Changes*. Rather, one or the other is to be used depending on the circumstances. As such, changes between these methods are not accounting changes. In addition, changes from the periodic method to the open year method would be seldom.

6.79 The zero balance method should not be used because it results in misstatement of the income statement by arbitrarily recognizing revenues and costs. The method also causes the profit to be reported in periods other than those in which the related premiums, claims, and expenses are reported.

Disclosures

6.80 Disclosure in the financial statements of an insurance company's accounting policies should include a description of the methods used to account

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[6] If the foreign ceding company maintains supplementary records that are sufficient to reasonably estimate earned premiums currently, then the U.S. assuming company should obtain the necessary information and use the periodic method to account for the foreign reinsurance.

for foreign reinsurance. In addition, for foreign reinsurance accounted for by the open year method, the following should be disclosed for each period for which an income statement is presented:

- The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances
- The additions to underwriting balances for the year for reported premiums, claims, and expenses.

Also, the amounts of premiums, claims, and expenses in the underwriting account should be disclosed for each balance sheet presented.

6.81

Exhibit 6.1

Topic D-54, *EITF Abstracts*, FASB Staff Announcements Regarding Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise Acquired in a Purchase Business Combination*

On ***November 14, 1996***, a FASB representative made the following announcement at the EITF meeting:

> The Insurance Companies Committee of the AICPA has notified the FASB staff that questions have been raised regarding whether FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, or APB Opinion No. 16, *Business Combinations*, should be applied to guarantees of the adequacy of liabilities existing at the acquisition date of a business combination, whether or not they are identified, for losses and loss adjustment expenses of short-duration insurance or reinsurance contracts of insurance enterprises (reserve guarantees) when the insurance enterprise is acquired in a business combination accounted for as a purchase. It appears that certain provisions of Statement 113 and Opinion 16 conflict with regard to accounting for those reserve guarantees.
>
> Reserve guarantees may be provided by a seller to indemnify a purchaser for unanticipated increases in the liabilities for losses and loss adjustment expenses of the subject insurance enterprise. They are most often provided with regard to liabilities for losses and loss adjustment expenses for coverages with long payout periods (long-tail coverages) for which the ultimate liability and/or the timing of the payout is difficult to estimate (for example, liabilities for losses and loss adjustment expenses relating to environmental and asbestos exposures). The selling and purchasing enterprises may, or may not, be insurance enterprises, and similar guarantees are provided in a business combination accounted for as a purchase that does not involve an insurance enterprise.

The scope of this announcement is limited to the accounting by a purchaser for reserve guarantees relating to the adequacy of liabilities existing at the acquisition date of a business combination, whether or not they are identified, for short-duration insurance contracts of an insurance enterprise when provided by a seller in a business combination accounted for as a purchase in accordance with the provisions of Opinion 16. This announcement should not be applied to a business combination accounted for as a pooling of interests or to other transactions that are not within the scope of Opinion 16, such as spin-offs or initial public offerings.

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* This Exhibit is taken from the FASB EITF Abstracts. FASB Statement No. 141, *Business Combinations*, addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16. FASB Statement No. 141 prohibits the use of the pooling-of-interests method. The provisions of FASB Statement No. 141 apply to all business combinations initiated after June 30, 2001. FASB Statement No. 141 also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. FASB Statement No. 141 does not apply, however, to combinations of two or more mutual enterprises. Additionally, the statement does not address reserve guarantees or EITF Abstract, Topic No. D-54, *Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise Acquired in a Purchase Business Combination*. However, the board may address these topics in the future.

The FASB staff believes that a purchaser, when accounting for reserve guarantees provided by a selling enterprise in a business combination accounted for as a purchase under the provisions of Opinion 16, should *not* apply paragraphs 22–24 of Statement 113, which address retroactive reinsurance arrangements. Reserve guarantees may be, and often are, provided between enterprises that are not insurance enterprises. The staff does not view reserve guarantees as being different from other guarantees of the existence of assets or the adequacy of liabilities often provided by the seller in a business combination accounted for as a purchase. The staff therefore believes that guarantees should be accounted for consistently regardless of whether or not the seller or purchaser is an insurance enterprise.

The FASB staff believes that changes in the liabilities for losses and loss adjustment expenses of the purchaser resulting from the continuous review process and the differences between estimates and payments for claims should be recognized in income by the purchaser in the period in which estimates are changed or payments are made in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; this includes those liabilities acquired in a business combination and subject to the reserve guarantee. The purchaser should at the same time recognize a receivable for the amount due from the seller under the reserve guarantee, subject to management's assessment of the collectibility of that amount, with a corresponding credit to income. Changes in the balance of the receivable that occur subsequent to recording the business combination should be included in income in the period that the estimates are changed (or payments are received, if resulting from differences between estimates and payments) and should not affect the acquiring enterprise's accounting for the business combination.

The Task Force observed that this announcement should be applied either as a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*, or prospectively to new business combinations entered into after November 14, 1996.

The SEC Observer noted that the SEC staff believes it is preferable to present the effects of the loss guarantee on a gross rather than net basis. The SEC Observer noted that any receivable from the seller should not be netted against the related liability in the balance sheet or in supporting information such as footnotes or SEC Industry Guide 6 disclosures. The SEC Observer also expressed a preference that (1) any expense associated with increased reserves be reported as a component of other claim losses and loss adjustment expenses, and (2) other claim losses and loss adjustment expenses not be reduced by the effect of the reserve guarantee.

However, after discussion of these preferences with the Task Force, the SEC staff indicated that it would not object to claim losses and loss adjustment expenses being reported net of the effect of the reserve guarantee in the income statement. A net presentation is appropriate only if the effects of the reserve guarantee are disclosed separately in the notes to the financial statements, in the SEC Industry Guide 6 disclosures including the reconciliation of claims reserves, and in the loss ratio information. In addition, the SEC staff believes the effects of such an arrangement on operations and cash flows should be clearly disclosed in management's discussion and analysis.

At the ***November 20, 1997*** meeting, FASB representatives announced that the FASB staff has received questions about whether *EITF Abstracts*, Topic No. D-54, *Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise*

Acquired in a Purchase Business Combination, applies to the purchaser's accounting for an arrangement in which the *seller* obtains reinsurance from a *third-party* reinsurer who agrees to directly indemnify the *purchaser* for increases in the liabilities for losses and loss adjustment expenses that existed at the acquisition date of a purchase business combination. The staff believes that the applicability of Topic D-54 to that and other arrangements that have circumstances that are similar to, but not the same as, the circumstances addressed in Topic D-54 should be determined based upon the specific facts and circumstances.[7] In order for the purchaser to apply the provisions of Topic D-54:

1. The seller must agree to participate in increases in the liabilities for losses and loss adjustment expenses that existed at the acquisition date of the purchase business combination. The seller may agree to indemnify the purchaser without remaining directly obligated for increases in the liabilities (for example, by funding its obligation through a reinsurance arrangement).

2. The guarantee arrangement between the purchaser and the seller must be contemporaneous with, and contingent on, the purchase business combination. The specific facts and circumstances should be considered in determining whether the guarantee arrangement is contemporaneous with the purchase business combination. The staff observes that to be contemporaneous, the guarantee arrangement should commit to *all* significant terms simultaneous with the consummation date of the purchase business combination. The absence of agreement on the significant terms, or the intention to establish or amend those terms at a later date, would result in the application of the provisions of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* to that guarantee arrangement. The fact that the purchaser is at risk for the subject increases in the liabilities for losses and loss adjustment expenses for any period after the effective date of the purchase business combination would indicate that the guarantee arrangement was not contemporaneous with that combination.

Illustrations

Following are explanations of how the above factors would be applied to illustrative guarantee arrangements between the seller and the purchaser, or between the seller, the purchaser, and one or more third parties:

1. Topic D-54 applies to a guarantee arrangement that is entered into contemporaneously with a purchase business combination in which the seller obtains a third-party indemnification (for example, a reinsurance arrangement) to reimburse the purchaser directly for unexpected increases in the liabilities for losses and loss adjustment expenses. However, the purchaser should apply the provisions of Statement 113 to an arrangement entered into directly by the purchaser with a third-party reinsurer because such an arrangement cannot be viewed as being contingent on the purchase business combination and because the seller has not participated in the arrangement.

2. The purchaser should apply Statement 113 to a guarantee arrangement that the seller and the purchaser enter into after the purchase

[7] This announcement is combined with Topic D-54 in *EITF Abstracts*.

business combination (regardless of whether the guarantee arrangement is in the form of a reinsurance arrangement) because that guarantee arrangement would not be contemporaneous with the purchase business combination.

Observation Related to Seller's Accounting

The staff also observes that the *selling* enterprise should apply the provisions of Statement 113 (assuming that the seller is an insurance enterprise to which the provisions of Statement 113 apply) to a reinsurance arrangement that it enters into before or after a purchase business combination, even if the *purchaser* is identified as the direct beneficiary of that reinsurance arrangement.

Business Combinations

Statement 141, which supersedes Opinion 16, was issued in June 2001. Statement 141 prohibits the use of the pooling-of-interest method for all business combinations initiated after June 30, 2001.

Chapter 7

Taxes

Federal Income Taxation

7.01 In general, a property and liability insurance company is subject to the same federal income tax laws that apply to other commercial enterprises. There are, however, additional sections of the Internal Revenue Code (IRC) and related Treasury regulations that apply specifically to property and liability insurers. Sections 831 and 832 of the IRC apply to all property and liability insurance companies. This chapter is intended to familiarize the auditor with significant and unique features of property and liability insurance taxation including the provisions of the Tax Reform Act of 1986 (TRA '86) and the Omnibus Budget Reform Act of 1990 (OBRA '90).

7.02 In addition, the following regulations may impact former regulations that have already been issued. These summaries are not necessarily inclusive of potential effects on an insurance enterprise.

- *The Omnibus Budget Reconciliation Act of 1993* enacted IRC section 197, and requires that acquired intangible assets such as insurance in force, goodwill and going concern value, be amortized by the straight-line method over 15 years. Additionally, specific rules apply to assumption reinsurance transactions and tax deferred acquisition costs. Moreover, corporate tax rates increased from 34% to 35%.
- *The Small Business Job Protection Act of 1996* provides market value accounting for modified guaranteed contracts.
- *The Health Insurance Portability and Accountability Act of 1996* changed the net operating loss carryback and carryforward provisions.
- *The Taxpayer Relief Act of 1997* reduced the carryback from 3 to 2 years and increased the carryforward from 15 to 20 years, as well as changing the general business credit carry periods to 1 year back and 15 years forward.
- *The IRS Restructuring Act of 1998* contains general corporate impacts that may affect property and liability companies.
- *The Job Creation and Worker Assistance Act of 2002* includes provisions for accelerated depreciation. It also extends the net operating loss carryback period for non-life insurance companies to 5 years for 2001 and 2002 losses.
- *Revenue Procedure 2002-46* provides guidance on the deduction of premium-related expenses and provides a safe harbor for the deduction of premium-related expenses by property and liability insurers. The expenses must be variable in amount and must be directly related to the premium written.

Provisions of TRA '86 on Property and Liability Insurance Companies

7.03 *Loss-reserve discounting.* Unpaid losses, including loss adjustment expenses, of a property and liability insurance company are subject to discounting for tax purposes. As a result, the deduction for unpaid losses is limited to the increase in the amount of discounted unpaid losses. The amount of discounted unpaid losses is computed annually with respect to unpaid losses in each line of business (as contained in Schedule P of the annual statement) for each accident year. The discount periods are generally three years for property lines and ten years for liability lines of business.

7.04 The provisions relating to the treatment of loss-reserve discounting are generally effective for taxable years beginning after December 31, 1986. For unpaid losses on business outstanding before January 1, 1987, the computation of a company's change in unpaid losses for the first year is determined as if the discounting provisions were applicable during the previous year. The income resulting from this decrease in reserves was not included in taxable income and was referred to as a "fresh start."

7.05 An example of the fresh-start provision follows. Assume that at December 31, 1986, the company's undiscounted loss reserves were $1000, and at December 31, 1987, they were $2000. Under pre-1987 law, the company would be entitled to a deduction of $1000 in 1987, representing the increase in undiscounted loss reserves during the year. Assume also that on a discounted basis, the loss reserves would be $900 and $1800 at December 31, 1986, and December 31, 1987, respectively. Without the fresh-start provision, the company would be entitled to a deduction of only $800 (discounted loss reserves of $1800, less undiscounted loss reserves of $1000) in 1987. However, the provision allows companies to measure their increase or decrease in reserves for 1987 by utilizing the discounted amount at December 31, 1986. In this example, therefore, the increase in reserves for 1987 is $900 ($1800 less $900), or $100 greater than it would have been if the company had been required to utilize its undiscounted reserve amount at December 31, 1986. The release of the discount at December 31, 1986, is *never* included in taxable income.

7.06 Discounting methodology is specified in the IRC. The amount of the discounted unpaid losses is the present value of such losses determined by using (*a*) the undiscounted loss reserves, (*b*) an applicable rate of interest, and (*c*) the pattern of the payment of claims.

7.07 Generally, the amount of the undiscounted unpaid losses subject to discounting is that shown in the annual statement. However, in some cases, reserves (such as workers' compensation) are already discounted for annual statement purposes. TRA '86 requires that these reserves be grossed up and that an undiscounted loss reserve be calculated. The undiscounted amount of the loss reserve is used as the amount of unpaid losses to which the discounting rules are applied. Insurance companies are permitted to gross up these discounted loss reserves for tax purposes only if the discounting for annual statement purposes is identified as such and the discounting factors that were used are explained in the annual statement. In addition, tax reserves cannot exceed annual statement reserves due to differing discount rates.

7.08 The interest rate to use in calculating the discounted reserve is an annual rate determined by the Secretary of the Treasury. The annual rate for any calendar year is a rate equal to 100 percent of the average of the applicable federal midterm rates (AFR) effective at the beginning of each of the calendar months in the test period. The test period is the most recent five-year period ending before the beginning of the year for which the determination is made. Any month beginning before August 1, 1986, is excluded from the test period. For accident years beginning before or in 1987, the interest rate is 100 percent of the average AFR effective at the beginning of the last five calendar months of 1986. Once an interest rate assumption is established for unpaid losses in a particular accident year, it continues to be used without change as claims for the accident year are paid.

7.09 The applicable loss-payment pattern is determined by the Secretary of the Treasury for each line of business by reference to the historical loss-payment pattern. Generally, the payment patterns are determined every five years based on published historical aggregate-loss-payment data or, at the company's election, each year based on its own historical loss-payment experience. For all years through 1991, the loss-payment patterns are based on 1985 data. Once a payment pattern has been applied to a particular accident year, it cannot be redetermined to adjust for more recent information. All losses are considered as being paid in the middle of the year. In place of the loss-payment-pattern provisions described above, an insurance company can make an irrevocable election to utilize its own historical loss-payment pattern (for example, the most recent experience as reported in its annual statement) in applying the general loss discounting rules for a taxable year. The election must be made for all lines of business for any determination year and applies for that determination year and the four succeeding calendar years. The determination year is defined as being calendar year 1987 and each fifth succeeding calendar year thereafter (such as 1987, 1992, 1997, and so forth). No election is permitted for any international or reinsurance line of business.

7.10 *Unearned premium reserve.* Under prior law, the entire annual change in a property and liability insurance company's unearned premium reserve was taken into account in computing its taxable income. In addition, property and liability insurers are entitled to deduct the expenses of issuing and selling new policies, such as policy acquisition expenses. Congress believed that allowing both a deferral of unearned premiums and a current deduction for the corresponding policy acquisition costs resulted in a significant mismatching of income and expense.

7.11 To provide for deferral of policy acquisition costs, TRA '86 permits only 80 percent of the annual change in the unearned premium reserve to be used in determining taxable income for taxable years beginning after December 31, 1986, for most lines of business. For certain financial guarantee businesses, the limitation is 90 percent. Congress deemed that the 20 percent not taken into account approximates policy acquisition costs. For example, in 1987, if an insurance company's unearned premium reserve increases from $50,000 to $60,000, the net deduction for unearned premiums will be $8,000 ($60,000 less $50,000 times 80 percent). Similarly, if the unearned premium reserve decreases in 1988 from $60,000 to $40,000, the insurance company will be required to include $16,000 (rather than $20,000, as under prior law) in determining taxable income.

7.12 *Dividends and tax-exempt interest.* TRA '86 requires a property and liability insurance company to prorate a specified portion of its investment income by reducing the deduction for losses incurred by 15 percent of its tax-exempt interest income and the deductible portion of dividends received. Dividends received from affiliates that are eligible for the 100-percent dividends-received deduction are also subject to proration if such dividends are funded by tax-exempt interest income or by dividends not eligible for the 100-percent dividends-received deduction. The proration rule applies to taxable years beginning after December 31, 1986, but only to tax-exempt interest and dividends received or accrued on bonds or stocks acquired after August 7, 1986.

7.13 *Small property and liability insurance companies.* Under prior law, mutual property and liability insurance companies with certain gross receipts of no more than $150,000 were exempt from tax. TRA '86 provides that stock companies as well as mutual property and liability insurance companies are eligible for tax exemption. A company is exempt from tax if it has both net written premiums and direct written premiums of no more than $350,000 for the taxable year.

7.14 In addition, TRA '86 enacted a provision that allows both mutual and stock property and liability companies to elect to be taxed only on investment income. This election is available if either net written premiums or direct written premiums exceed $350,000 but neither amount exceeds $1,200,000. The amount of the net or direct written premiums is determined on a controlled group basis with a 50-percent rather than an 80-percent ownership test.

7.15 *Protection against loss account.* Under prior law, mutual property and liability insurance companies were permitted a protection against loss (PAL) account deduction. The PAL account, which was originally enacted to provide for the cyclical nature of the industry, is a memorandum account that allowed a mutual property and liability insurer to defer a portion of its underwriting income.

7.16 In an attempt to reduce the differences between mutual and stock companies, TRA '86 repeals the deduction for additions to the PAL account effective for taxable years beginning after December 31, 1986. Amounts in the PAL account at the close of the last taxable year beginning before January 1, 1987, are included in income in the same manner as under prior law.

7.17 *Alternative minimum tax.* For taxable years beginning after December 31, 1986, TRA '86 repealed the corporate add-on minimum tax and replaced it with an alternative minimum tax (AMT). In addition, TRA '86 requires a property and liability insurance company to take into account its AMT liability and regular tax liability in making estimated tax payments. As of 1990, adjusted current earnings (ACE) is used for calculating the alternative minimum tax.

7.18 *Adjusted current earnings.* The adjusted current earnings (ACE) adjustment is equal to taxable income plus a number of adjustments and preferences, the most significant of which for property and casualty companies will be the inclusion of the untaxed portion of tax-exempt interest and the dividends-received deduction (DRD) applicable to portfolio stocks (70 percent DRD). The DRDs relating to companies in which the taxpayer owns at least 20 percent but less than 80 percent (80 percent DRD) and for which the taxpayer owns 80 percent or more (100 percent DRD) are not included in ACE. AMTI will be increased by 75 percent of the amount by which ACE, rather than book income, exceeds AMTI before this adjustment. For many property and liability companies, ACE can be approximated by simply adding 75 percent of tax-exempt interest and 75 percent of the 70 percent of the DRD to regular taxable income.

Statutory Accounting Practices and Taxable Income

7.19 A property and liability insurance company's taxable income is based in large part on its statutory financial statements. The underwriting and investment exhibit of the annual statement approved by NAIC is accepted by the IRS as the net income of the company; and insofar as it is not inconsistent with the provisions of the IRC, the exhibit is recognized and used as a basis for determining the gross amount earned from investment and underwriting income for tax purposes.

7.20 SSAP No. 10, *Income Taxes,*[1] paragraphs 5 and 7 note that under SAP "A reporting entity's balance sheet should include deferred income tax assets (DTAs) and liabilities (DTLs), the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of FAS 109... Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus)."

7.21 There are three other unique and prominent similarities between statutory and taxable income. First, commissions, premium taxes, and other costs of acquiring new business are fully deductible for tax purposes in the year that they are incurred, although the related income is included in subsequent tax periods. Second, direct charges or credits to statutory surplus are not included in determining taxable income. They include premiums past due from agents—unless they are bona fide bad debts currently chargeable to statutory expense—and the provision for unauthorized reinsurance. Third, premiums are included in taxable income only as they are earned, regardless of when they are received.

7.22 Although most of the accounting practices for determining taxable income as prescribed by the IRC follow statutory accounting practices, there are items that are always excluded from or are deductible in computing taxable income, such as tax-exempt interest received on certain bonds, and the dividends-received deduction. The IRC and regulations of the IRS also differ from statutory practices in certain respects for salvage and subrogation, policyholder dividends, and deposit premiums.

7.23 *Policyholder dividends.* Under statutory accounting practices, policyholder dividends are charged to expense on the date they are declared; the IRC permits policyholder dividends to be deducted on the date declared, the date payable, or the date paid, as long as the chosen method is consistently followed.

7.24 *Deposit premiums.* Deposit premiums are provisional payments by policyholders that are adjusted when the policies expire, based on the coverage provided. They are most commonly used for workers' compensation insurance. Statutory accounting practices allow several methods of recognizing deposit premiums. For federal income tax purposes, the includable portion of the premium is the amount received, less the amount of unabsorbed premium deposits that the company would be obligated to return to its policyholders at the close of the taxable year if all its policies were terminated at that date.

Special Income Tax Provisions

7.25 *Capital losses.* The IRC treats the deductions for capital losses of property and liability insurers differently from those of other corporate taxpayers in certain unusual circumstances. Property and liability insurers may claim ordinary deductions for capital losses resulting from the sale or exchange

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[1] Readers should refer to *A Guide to Implementation of SSAP No. 10 on Accounting for Income Taxes: Questions and Answers*, which provides further guidance on the application of SSAP No. 10, including clarification on the admissibility calculation.

of capital assets in order to obtain funds to meet abnormal insurance losses and to provide for the payment of dividends and similar distributions to policyholders. Insurance companies use a prescribed calculation to determine whether securities were sold to meet abnormal losses. Capital losses are ordinary deductions to the extent that gross receipts from assets sold do not exceed the excess of cash-basis income over cash-basis expense.

GAAP Accounting for Income Taxes

7.26 In February 1992, the FASB issued FASB Statement No. 109, *Accounting for Income Taxes*. FASB Statement No. 109 supersedes Statement No. 96, *Accounting for Income Taxes*, and APB Opinion No. 11, *Accounting for Income Taxes*.

7.27 FASB Statement No. 109 prescribes an asset and liability method of accounting for income taxes. Under the asset and liability method the emphasis in accounting for income taxes is on the balance sheet rather than on the income statement. The asset and liability method accounts for deferred income taxes by applying enacted statutory tax rates in effect at the balance sheet date to the temporary differences between the recorded financial statement balances and the related tax bases of assets and liabilities. The resulting deferred tax liabilities and assets are adjusted to reflect changes in tax laws and rates in the period of enactment.

Basic Principles of Accounting for Income Taxes

7.28 The following basic principles are applied in accounting for income taxes at the date of the financial statements:

- A current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year.
- A deferred tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences and carryforwards.
- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance that represents the amount of any tax benefits that, based on available evidence, are not expected to be realized.

Temporary Differences—GAAP and SAP

7.29 FASB Statement No. 109 introduces the term temporary difference. A temporary difference arises when the tax bases of assets and liabilities differ from those reported in the financial statements.

7.30 For property and liability insurance companies, the more significant temporary differences include:

- *Deferred policy acquisition costs.* Because certain acquisition costs are deferred for financial statement purposes but expensed when incurred for tax purposes, a temporary difference exists in the amount of the deferred policy acquisition cost asset.
- *Unearned premium reserve.* Under TRA '86, only 80 percent of the change in the unearned premium reserve of a property and casualty insurer is considered in computing taxable income. Thus, a temporary difference exists for the 20 percent nondeductible portion of the unearned premium reserve.

- *Loss and loss expense reserves.* TRA '86 requires the discounting of all property and casualty loss reserves and certain accident and health claim reserves. Generally, such reserves are not discounted for financial statement purposes. A temporary difference will exist in the amount of the difference between the financial statement reserves and the tax basis of reserves.
- *Investments.* Net unrealized gains or losses on investments in equity securities, as well as any permanent impairment write-downs of investments recognized in the financial statements, are considered temporary differences. Generally, market discount on bonds is not subject to tax until the bonds mature or are sold. The accrual of market discount for financial statement purposes creates a temporary difference for which deferred taxes should be recognized. Under SAP, temporary differences can include unrealized gains and losses and nonadmitted assets, but do not include AVR and IMR (see SSAP No. 10, paragraph 10 for discussion of computing DTAs and DTLs).

7.31 Items that will never have a tax consequence are not considered temporary differences. Examples of such items include tax-exempt interest and the dividends-received deduction.

7.32 Temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year.

7.33 FASB Statement No. 109 requires that a deferred tax liability be recognized for all taxable temporary differences and a deferred tax asset be recognized for all deductible temporary differences and operating loss and tax credit carryforwards. A *valuation allowance* should be recognized if it is more likely than not that some portion or all of the deferred tax asset will not be recovered.

7.34 Because FASB Statement No. 109 requires that calculations of deferred tax assets and liabilities be performed separately for each tax jurisdiction, detailed records of temporary differences may be required for each tax jurisdiction in which the entity is subject to income taxes. As the alternative minimum tax introduced by TRA '86 is deemed to be a separate but parallel tax system, detailed records of temporary differences under this system may also be required.

7.35 Under SAP, an admissibility test must be used to determine how much of the gross deferred tax assets should be admitted. A valuation allowance, as determined under FASB Statement No. 109, does not exist for SAP. SSAP No. 10, paragraph 10, notes the "gross DTAs shall be admitted in an amount equal to the sum of:

a. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year;

b. The lesser of:

(i) The amount of gross DTAs, after the application of paragraph 10a expected to be realized within one year of the balance sheet date; or

(ii) Ten percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and

c. The amount of gross DTAs, after application of paragraphs 10a and 10b, that can be offset against existing gross DTLs."

Changes in Tax Law

7.36 Under the asset and liability method, deferred taxes represent liabilities to be paid or assets to be received in the future. Accordingly, deferred tax assets and liabilities are adjusted to reflect a change in tax law or rates. The effect of the change is recognized as a component of income tax expense in the period the tax law change is enacted. Under SAP, as noted in SSAP No. 10, changes in DTAs and DTLs attributable to changes in tax rates and tax status should be recognized as a separate component of gains and losses in surplus.

Financial Statement Presentation and Disclosure

7.37 Paragraphs 41 and 42 of FASB Statement No. 109 set forth financial statement presentation principles related to deferred tax assets and liabilities.

7.38 Separate balance sheet presentation of current refundable income taxes or income taxes payable and deferred income taxes for each tax jurisdiction (federal, state, and each foreign tax jurisdiction) should be made (for example, a federal deferred tax asset should not be netted against a state deferred tax liability). The following components of the net deferred tax liability or asset recognized in the property and liability insurer's balance sheet should be disclosed:

- The gross amount of all deferred tax liabilities.
- The gross amount of all deferred tax assets; for SAP this also includes nonadmitted DTAs as per the admissibility test in SSAP No. 10 and net change in total DTAs nonadmitted.
- The amount of any valuation allowance reducing the amount of deferred tax asset and any change in the valuation allowance during the period. Under SAP, amounts determined to be uncollectible are written off and are not classified to a valuation allowance.

7.39 Property and liability insurance entities registered with the SEC should disclose the approximate tax effect of each significant type of temporary difference and carryforward (before allocation of valuation allowances). Non-SEC registrants should disclose the types of significant temporary differences and carryforwards, but may omit disclosure of the tax effects for these items.

7.40 Whenever a deferred tax liability is not recognized because of certain exceptions under APB Opinion No. 23, *Accounting for Income Taxes-Special Areas* (as amended by FASB Statement No. 109), the following information should be disclosed:

- Description and cumulative amount of significant types of temporary differences for which a deferred tax liability has not been recognized, and the types of events that would cause those temporary differences to become taxable.

- Amount of unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign joint ventures that are essentially permanent in duration, if determination of that liability is practicable, or a statement that determination is not practicable.
- The amount of the deferred tax liability for other temporary differences that is not recognized in accordance with the provisions of paragraphs 31 and 32 of FASB Statement No. 109.

7.41 Examples of temporary differences of property and liability insurance companies for which a deferred tax liability is not recognized unless it becomes apparent that those temporary differences will reverse in the foreseeable future:

- Excess book basis over the tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration.
- Undistributed earnings of a domestic subsidiary or corporate joint venture that are permanent in duration and arose in fiscal years beginning on or before December 15, 1992.

7.42 The significant components of income tax expense for continuing operations for each period presented should be disclosed and may include the following:

- Current tax expense or benefit.
- Deferred tax expense or benefit (exclude other components that are disclosed separately).
- Investment tax credits and government grants.
- The benefits of operating loss carryforwards.
- Adjustments of a deferred tax liability or asset resulting from enacted changes in tax laws and rates or a change in the tax status of the property and liability insurance company.
- Adjustments to beginning balance of valuation allowances resulting from a change in circumstances that causes a change in the assessment of the realizability of the deferred tax asset in future years.
- Tax expense that results from allocating certain tax benefits either directly to (*a*) contributed capital or (*b*) goodwill or other noncurrent intangible assets of an acquired entity.

7.43 The amount of income tax expense or benefit amount allocated to (*a*) continuing operations, (*b*) discontinued operations, (*c*) extraordinary items, (*d*) other comprehensive income, and (*e*) shareholders' equity should be disclosed. For example, the amount of income tax expense or benefit attributable to certain items whose tax effects are charged or credited directly to other comprehensive income or related components of shareholder's equity, such as translation adjustments under FASB Statement No. 52, *Foreign Currency Translation*, or changes in the carrying amount of available-for-sale securities under FASB Statement No. 115, should be separately allocated and disclosed.

7.44 SEC registrants are required to disclose a reconciliation using percentages or dollar amounts of the current year's tax expense attributable to continuing operations to the amount of tax expense computed by applying the federal statutory tax rate to pre-tax income from continuing operations of the current year. The estimated amount and nature of each significant reconciling item should be disclosed. Non-SEC registrants are required to disclose the nature of significant reconciling items. This is usually satisfied by a footnote describing the nature of the reconciling items without any quantitative disclosure. This reconciliation is also required for SAP, per SSAP No. 10 paragraph 21, to reconcile the difference between the income taxes incurred and the changes in the DTAs and DTLs to the result of applying the federal statutory rate to pretax net income.

7.45 The amounts and expiration dates of net operating loss and tax credit carryforwards should be disclosed. Further, a property and liability insurance company is required to disclose the amount of any valuation allowance for which subsequently recognized tax benefits will be allocated directly to (*a*) reduce goodwill or other non-current intangible assets of an acquired entity or (*b*) contributed capital.

7.46 A property and liability insurance company that joins in the filing of a consolidated tax return with its parent and affiliates must disclose in its separately-issued financial statements the method for allocating and settling the consolidated income taxes among the members of the group, which should be in accordance with the principles in FASB Statement No. 109. The aggregate amount of current and deferred tax expense and any tax-related balances due to or from affiliates also should be disclosed.

7.47 The objectives of auditing income taxes are to obtain reasonable assurance that—

- The provision for income taxes and the reported income tax liability or receivable are properly measured, valued, classified, and described in accordance with the generally accepted accounting principles.
- Deferred income tax liabilities and assets accurately reflect the future tax consequences of events that have been recognized in the property and liability insurance company's financial statements or tax returns (temporary differences and carryforwards).

7.48 The independent accountant should be aware that the tax laws specific to property and liability insurance companies, as well as to general corporate taxation, can change from year to year.

7.49 Under SAP, additional disclosures are required if an entity's federal income tax return is consolidated with those of any other entity, see SSAP No. 10 paragraph 23. Refer to SSAP No. 10, paragraphs 17 through 23 for a complete list of statutory disclosure requirements.

Internal Control and Possible Tests of Control

7.50 It is generally more efficient and effective to assess control risk at the maximum for income taxes and take an entirely substantive approach. The independent accountant should, however, obtain an understanding of relevant controls to plan effective substantive tests.

Substantive Tests

7.51 Substantive audit procedures may include the following:

- Obtain a schedule reconciling net income per books with taxable income for federal, state, and foreign income taxes. Agree entries to general ledger and supporting documents as appropriate. Consider the reasonableness of the current tax account balances.

- Examine prior year income tax returns, and ascertain the latest year for which returns have been examined. Review recent Revenue Agent Reports, if any, and consider current treatment of items challenged by the taxing authorities in prior years.
- Update or review the schedule of cumulative temporary differences, reviewing for propriety, and test the reasonableness of the income tax amounts.
- Review and determine the need for and appropriateness of any valuation allowance for deferred tax assets based upon available evidence. The auditor should recognize that institutions often may have a significant deferred tax asset resulting from the loan loss reserve. This asset should be evaluated based upon the likelihood of realization, taking into account the timing of the bad debt deduction, and the special operating loss carryforwards and carryback tax rules, if applicable.
- Consider the deductibility of transactions such as profit-sharing, bonus, contributions, or stock option transactions.
- Review classification and description of accounts to identify possible tax reporting differences, such as reserves for anticipated losses or expenses.
- Review the tax status and consolidated return requirements of subsidiaries.
- Review the status of current year acquisitions of other companies and their preacquisition tax liabilities and exposures.
- Review the utilization of carryforwards.
- Review the allocation, apportionment, and sourcing of income and expense applicable to state tax jurisdictions with significant income taxes.
- For separate financial statements of affiliates, review terms of all tax-sharing agreements between affiliated entities to determine proper disclosure and accounting treatment. The auditor should be cognizant of and consider whether the institution is in compliance with the regulatory accounting rules for intercompany tax allocation and settlement.
- Review schedule of net operating loss and other tax credit carryforwards.
- Review tax planning strategies and assumptions utilized in the calculation of deferred income taxes under FASB Statement No. 109.
- Test the roll-forward of tax balance sheet accounts. Consider vouching significant tax payments and credits.
- Review reconciliation of prior year tax accrual to the actual filed tax return. Determine the propriety of adjustments made in this regard and consider the impact on current year's tax accrual.
- Evaluate tax contingencies and consider the appropriate accounting treatment and disclosure requirements for these items under FASB Statement No. 5.
- Ascertain whether changes in income tax laws and rates have been properly reflected in the tax calculations and account balances.
- Evaluate the adequacy of the financial statement disclosures.

Net Operating Loss and Tax Credit Carryforwards

7.52 FASB Statement No. 109 generally requires that the tax benefit of a loss carryforward be reported as a reduction of income tax expense.

Other Issues

7.53 The following discussion highlights other changes to current accounting practice required by FASB Statement No. 109 and specific implementation issues confronting the insurance industry.

Unrealized Gains and Losses

7.54 Unrealized gains and losses are considered temporary differences for which deferred taxes computed under the Statement's intraperiod tax allocation provisions are measured and recorded through a direct charge or credit to other comprehensive income.

7.55 Deferred tax assets should be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the deferred tax asset will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

7.56 Net unrealized gains and losses should be considered to be temporary differences. The period in which net gains and losses on marketable securities are realized is dependent upon management's future investment decisions.

Accounting for the "Fresh Start"

7.57 TRA '86 grants insurers a "fresh start" on the difference between ending 1986 undiscounted loss reserves and beginning 1987 discounted loss reserves, meaning that such difference need not be included in post-1986 taxable income. This creates a temporary difference that will result in deductible amounts in future periods.

7.58 Under FASB Statement No. 109, the difference between the financial statement reserve liability and the tax basis of reserves (including fresh start) is a temporary difference.

The Alternative Minimum Tax

7.59 The alternative minimum tax may be the most significant and complex aspect of TRA '86. The objective of the AMT is to ensure that no taxpayer with substantial "economic income" can avoid paying tax by using exclusions, deductions, and credits. The FASB's Emerging Issues Task Force reached a consensus, as described in EITF Issue No. 87-8, *Tax Reform Act of 1986: Issues Relating to the Alternative Minimum Tax*, on several key issues relating to the accounting for the AMT under APB Opinion No. 11. Of primary significance was the decision to view the AMT as a separate but parallel tax system. The federal tax liability is considered to be the greater of the amount calculated under the regular tax system or the AMT system. However, the excess of the AMT over the regular tax is generally available as an AMT credit carryforward to future years.

7.60 Under FASB Statement No. 109, the AMT credit carryforward is reflected as a prepayment of regular tax and reported as a deferred tax asset subject to a valuation allowance.

APB Opinion No. 23: *Accounting for Income Taxes—Special Areas*

7.61 FASB Statement No. 109 requires additional financial statement disclosures regarding temporary differences from undistributed earnings of subsidiaries and corporate joint ventures and the amounts designated as policyholders' surplus of stock life insurance companies.

Interim Financial Reporting

7.62 FASB Statement No. 109 amends FASB Statement No. 16, *Prior-Period Adjustments*, to eliminate the requirement to restate prior interim periods for the effects of new retroactive tax legislation. The effects of changes in tax laws or rates are to be recorded in the interim period in which the tax law change is enacted.

State Taxation

7.63 Various state governments tax property and liability insurers on premiums written and on income. Taxation methods and tax rates vary widely among the states. Many of the states apply different rates to different lines of insurance and differentiate between domestic insurers and foreign insurers.

7.64 *Premium taxes.* All states tax premiums. These taxes usually apply both to the companies that are domiciled in the state, called *domestic insurers,* and to the companies that conduct business in the state but are domiciled elsewhere, called *foreign insurers.* Some states, however, partially or totally exempt domestic insurers from premium taxes, and others allow domestic insurers special credits against premium taxes if they invest specified amounts of assets in domestic corporations. The premium tax base is generally direct premiums written less returned premiums on the business within the taxing state. The tax rates vary by state.

7.65 Some states require quarterly premium tax payments; however, most states require premium tax payments in February of the year following the year that the premiums were written. Insurers thus generally have substantial premium tax liabilities as of December 31 of each year. Rather than computing the liability on a state-by-state basis, most companies estimate their total premium tax payable using their historical ratio of total premium tax expense to total premiums written. This ratio is applied to current premiums written to compute the current premium taxes for the fiscal year. The total liability is then adjusted for prepaid premium taxes to arrive at the accrued premium tax liability. The company should evaluate the ratio annually, because shifts in the concentration of the company's business from state to state and changes in state tax laws can significantly affect an insurer's premium tax liability.

7.66 *State income taxes.* In addition to premium taxes of insurance companies, some states tax the net income of domestic insurers in one way or another. Some also tax the net income of foreign insurers. Generally, however, various methods are used to avoid double taxation. The methods include (*a*) allowing the insurer to elect to be taxed on either premiums or net income, (*b*) allowing a credit on one of the tax returns for taxes paid on the other, and (*c*) exempting domestic insurers from the premium tax.

7.67 States that tax the income in addition to or in place of the premium tax of property and liability insurance companies generally base the computation of taxable income on federal taxable income, with certain modifications. Apportionment and allocation of income by multistate companies are important considerations when accruing for such taxes.

7.68 The prior-year apportionment percentage is generally indicative of the current year for computing the accrual. Significant changes in the places in which the company does business, however, can affect apportionment and should be considered when testing the adequacy and reasonableness of the accrual for state franchise or income taxes.

Chapter 8

Reports on Audited Financial Statements

Reports on Financial Statements

8.01 The guidance in Statement on Auditing Standards (SAS) No. 58, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements, and by SAS No. 93, *Omnibus Statement on Auditing Standards—2000* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), applies to reports on audited generally accepted accounting principles (GAAP) financial statements of insurance entities. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, a disclaimer of opinion, or an adverse opinion. This chapter contains a brief discussion of each of these reports, with an emphasis on illustrating issues that an auditor may encounter in auditing the financial statements of insurance entities. Guidance on reporting on statutory financial statements is incorporated from Statement of Position (SOP) 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*, as amended. The guidance incorporated from SOP 95-5 reflects changes by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification.*

8.02 The illustrative auditors' reports in this chapter are presented to assist auditors in drafting their reports under various circumstances. Each illustration intentionally describes the same general fact situation to avoid suggesting that particular facts always lead to a particular form of opinion. The reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report.

Unqualified Opinions on GAAP Financial Statements

8.03 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with GAAP. This conclusion may be expressed only if the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). The following is an illustration of an auditor's standard report (unqualified opinion) on the GAAP basis financial statements of an insurance entity.

Independent Auditor's Report

To the Board of Directors and Shareholders
ABC Property and Liability Company

We have audited the accompanying balance sheets of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

Unqualified Opinions With Explanatory Language

Emphasis of a Matter

8.04 In a number of circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, the auditor may wish to emphasize that the insurance entity is a component of a larger business entity or that it has had significant transactions with related parties, or the auditor may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period.

Such explanatory information should be presented in a separate paragraph of the auditor's report (either preceding or following the opinion paragraph). Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this kind. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion.

The following is an illustration of an unqualified opinion on the GAAP financial statements of an insurance entity with an emphasis of a matter regarding the entity's failure to meet minimum risk-based capital (RBC) standards. The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. A similar paragraph could be adapted for use in an opinion on statutory-basis financial statements. They are not intended to provide criteria or other guidelines to be used by auditors in deciding whether an explanatory paragraph should be added to their reports.

Independent Auditor's Report

To the Board of Directors and Shareholders
ABC Property and Liability Company

We have audited the accompanying balance sheets of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note XX to the financial statements, [State of domicile's insurance regulatory body] imposes risk-based capital requirements on insurance entities, including the Company. At December 31, 20X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [State of domicile's insurance regulatory body].

[*Signature*]

[*Date*]

Uncertainties

8.05 A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include but are not limited to contingencies covered by FASB Statement No. 5, *Accounting for Contingencies*, and matters related to estimates and other matters covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.*

8.06 Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is or should be available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

8.07 If the auditor is unable to obtain sufficient evidential matter to support management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualified opinion or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

8.08 Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated attributable to departures from GAAP related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates.

8.09 *Inadequate Disclosure.* If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with GAAP or statutory accounting practices, the auditor should express a qualified or an adverse opinion.

8.10 The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by his perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to the auditor's evaluation of the materiality of known and likely misstatements in the financial statements.

8.11 *Inappropriate Accounting Principles.* In preparing financial statements, management estimates the outcome of certain kinds of future events. Paragraphs 23 and 25 of FASB Statement No. 5 describe situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion.

8.12 *Unreasonable Accounting Estimates.* Usually, the auditor is able to obtain satisfaction regarding the reasonableness of management's estimate of the effects of future events by considering various kinds of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable and that its effect is to cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion.

Going Concern

8.13 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), describes the auditor's responsibility for evaluating whether substantial doubt exists concerning the ability of the entity being audited to continue as a going concern for a reasonable period of time. Chapter 2, "Audit Considerations," describes going-concern considerations as they relate to property and liability insurance entities and discusses how an insurance entity's regulatory capital position should be considered in the auditor's assessment of whether there is substantial doubt about the insurance entity's ability to continue as a going concern. If the auditor concludes that there is substantial doubt about an insurance entity's ability to continue as a going concern for a reasonable period of time, the report should include an explanatory paragraph (following the opinion paragraph) to express that conclusion or disclaim an opinion. (See paragraph 8.14.) The auditor's conclusion about the insurance entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about the insurance entity's ability to continue as a going concern," or similar wording that includes the terms substantial doubt and going concern. The following is an illustration of an auditor's report (unqualified opinion) on the GAAP financial statements of an insurance entity that includes an explanatory paragraph because of the existence of substantial doubt about the insurance entity's ability to continue as a going concern for a reasonable period of time. The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. A similar paragraph could be adapted for use in an opinion on statutory-basis financial statements. They are not intended to provide criteria or other guidelines to be used by auditors in deciding whether an explanatory paragraph should be added to their reports.

Independent Auditor's Report

To the Board of Directors and Shareholders
ABC Property and Liability Company

We have audited the accompanying balance sheets of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that ABC Property and Liability Company will continue as a going concern. As discussed in Note XX to the financial statements, [State of domicile's insurance regulatory body] imposes risk-based capital requirements on insurance entities, including the Company. At December 31, 20X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [State of domicile's insurance regulatory body]. The Company has filed a comprehensive financial plan with the commissioner outlining the Company's plans for attaining the required levels of regulatory capital by December 31, 20XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of ABC Property and Liability Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

8.14 SAS No. 59 states that inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report (as described above in paragraph 8.13) serves adequately to inform users of the financial statements of the auditor's substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Nonetheless, SAS No. 59 does not preclude the auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the auditor's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an auditor's report containing a disclaimer of opinion as the result of uncertainties relating to an auditor's substantial doubt about an insurance entity's ability to continue as a going concern for a reasonable period of time.

Independent Auditor's Report

To the Board of Directors and Shareholders
ABC Property and Liability Company

We were engaged to audit the accompanying balance sheet of ABC Property and Liability Insurance Company as of December 31, 20X2, and the related statements of income, changes in stockholders' equity, other comprehensive income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management.

The accompanying financial statements have been prepared assuming that ABC Property and Liability Company will continue as a going concern. As discussed in Note XX to the financial statements, [State of domicile's insurance regulatory body] imposes risk-based capital requirements on insurance entities, including the Company. At December 31, 20X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [State of domicile's insurance regulatory body]. The Company has filed a comprehensive financial plan with the commissioner outlining its plans for attaining the required levels of regulatory capital by December 31, 20XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of ABC Property and Liability Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 20X2.

[*Signature*]

[*Date*]

Qualified Opinion

8.15 SAS No. 58, as amended by SAS No. 79 (AICPA, Professional Standards, vol. 1, AU sec. 508.20), describes certain circumstances that may require the auditor to qualify the opinion on the financial statements. A qualified opinion states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is issued under the following circumstances.

a. There is a lack of sufficient competent evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that an unqualified opinion cannot be expressed and the auditor has concluded not to disclaim an opinion.

b. The auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion.

Disclaimer of Opinion

8.16 SAS No. 58, as amended by SAS No. 79 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.61), describes disclaimers of opinion. A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with GAAP. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer. A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statements. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from GAAP.

8.17 When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. The opinion should state that the scope of the audit was not sufficient to warrant the expression of an opinion. In addition, the report should disclose any other reservations the auditor has regarding fair presentation in conformity with GAAP. The auditor should not identify the procedures that were performed or include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer.

Adverse Opinion

8.18 SAS No. 58, as amended by SAS No. 79 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.58), describes adverse opinions. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed if, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. When expressing an adverse opinion, the auditor should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (*a*) all the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable. If the effects are not reasonably determinable, the report should so state. If an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

Auditors' Reports on Statutory Financial Statements of Insurance Entities*

8.19 All states require domiciled insurance entities to submit to the state insurance commissioner an Annual Statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the Annual Statements. Statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the regulatory authority of the state of domicile," referred to in this Audit and Accounting Guide (the Guide) as statutory accounting practices. Statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) as described in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623).

NAIC-Codified Statutory Accounting

8.20 In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual*, effective January 1, 2001 (the revised Manual). The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law.

8.21 Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the revised Manual in whole or in part as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions,

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* The guidance contained in this section is based on SOP 95-5 and reflects the amendments to SOP 95-5 as made in SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification.*

those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

8.22 Permitted statutory accounting practices include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the state prescribed statutory accounting practices or (*b*) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

General Use Reports

8.23 If an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the regulatory authorities to whose jurisdiction the insurance entity is subject, the auditor of those statements should use the general use form of report for financial statements that lack conformity with GAAP [SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623)]. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 544.04, "Lack of Conformity with Generally Accepted Accounting Principles"), requires the auditor to use the standard form of report described in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), as amended, modified as appropriate because of departures from GAAP.

8.24 Although it may not be practicable to determine the amount of difference between GAAP and statutory accounting practices, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance entities' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and statutory accounting practices are material and pervasive. Auditors should express an adverse opinion with respect to conformity with GAAP (see SAS No. 58 [AICPA, *Professional Standards*, vol. 1, AU sec. 508.58]), unless the auditor determines the differences between GAAP and statutory accounting practices are not material and pervasive.

8.25 The auditor, when expressing an adverse opinion, is required to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (*a*) all of the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[1] (See SAS No. 58 [AICPA, *Professional Standards*, vol. 1, AU sec. 508.59–.60].) If the effects are not reasonably determinable, the report should so state

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[1] AU section 431, *Adequacy of Disclosure in the Financial Statements*, of the AICPA *Professional Standards*, defines practicable as ". . .the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the auditors report.

and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss statutory accounting practices and describe how those practices differs from GAAP.

8.26 After expressing an opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with statutory accounting practices. If departures from statutory from statutory accounting practices are found to exist and are considered to be material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 regarding conformity with GAAP.

8.27 Following is an illustration of an independent auditor's report on the general-use financial statements of an insurance enterprise prepared in conformity with statutory accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with statutory accounting practices. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and the statutory accounting practices are not reasonably determinable.

Independent Auditor's Report

To the Board of Directors
ABC Property and Liability Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [State of domicile], which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

Limited Use Reports

8.28 Prescribed-or-permitted statutory accounting practices for insurance enterprises are considered an other comprehensive bases of accounting (OCBOA) as described in SAS No. 62. If an insurance entity's statutory financial statements are intended solely for filing with state regulatory authorities to whose jurisdiction the insurance entity is subject, the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. Such reporting is appropriate even though the auditor's report may be made a matter of public record (AICPA, *Professional Standards*, vol. 1, AU sec. 623.05f). However, that paragraph further states that limited use reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance entity is subject. The auditor's report should contain a statement that there is a restriction on the use of the statutory financial statements to those within the insurance enterprise and for filing with the state regulatory authorities to whose jurisdiction the enterprise is subject.

8.29 Although auditing standards do not prohibit an auditor from issuing limited use and general use reports on the same statutory financial statements of an insurance entity, it is preferable to issue only one of those types of reports. Few, if any, insurance enterprises that do not prepare financial statements in conformity with GAAP will be able to fulfill all of their reporting obligations with limited use statutory financial statements.

8.30 Following is an illustration, adapted from paragraph 8 of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623.08), of an unqualified auditor's report on limited use financial statements prepared in conformity with statutory accounting practices.

Independent Auditor's Report

To the Board of Directors
ABC Property and Liability Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows, for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [State of domicile] which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and the management of ABC Property and Liability Company and state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

General Use and Limited Use Reports

8.31 The notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discusses statutory accounting practices and describes how this basis differs from GAAP (AICPA, *Professional Standards*, vol. 1, AU sec. 623.10.) In general use statutory financial statements, the effects of the differences should be disclosed, if quantified. However, in limited use statutory financial statements, the effects of the differences need not be quantified or disclosed.

8.32 The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.11), and SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623.31), regardless of any of the following.

a. The type of report—general use or limited use.

b. The opinion expressed—unqualified, qualified, or adverse.

c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory accounting practices.

For example, in a general use report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the statutory accounting practices, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance entity's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

8.33 The auditor may wish to emphasize a matter in a separate paragraph of the auditor's report (AICPA, *Professional Standards*, AU secs. 508.37 and 623.31). When an insurance entity prepares its financial statements using accounting practices prescribed or permitted by the regulatory authority of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance entity's statutory capital, the auditor is strongly encouraged to include an emphasis-of-matter paragraph in the report describing the permitted practices and their effects on statutory capital.

8.34 An example of an emphasis-of-matter paragraph follows:

> As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [State of domicile] in 20XX to write up its home office property to appraised value; under prescribed statutory accounting practices home office property is carried at depreciated cost. As of December 31, 20X5, that permitted accounting practice increased statutory surplus by $XX million over what it would have been had the prescribed accounting practices been followed.

8.35 If subsequent to the initial adoption of the revised Manual there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph of the report (AICPA, *Professional Standards*, vol. 1, AU sec. 508.16). The explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer to the note in the financial statements that discusses the change. The auditor's concurrence with a change is implicit, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the statutory accounting practices.

8.36 An example of an explanatory paragraph follows:

> As discussed in Note X to the financial statements, the Company changed its method of accounting for guaranty funds and other assessments.

Special Reports

8.37 In connection with regulatory requirements, states have required the filing of special reports, such as those on loss reserves and internal control. In addition, independent auditors may provide other services in connection with regulatory requirements, such as NAIC examinations, or other services, to comply with state regulations. Special reports such as that illustrated in Exhibit 8.1 may also apply in other circumstances. Certain regulatory authorities may request opinions on loss reserves in connection with licensing applications or other planned transactions. For example, an insurance company holding a certificate of authority as surety on federal bonds may be required to submit to the U.S. Treasury Department a report by an independent auditor on its loss reserves.

Special Reports on Loss Reserves

8.38 Exhibit 8.1 illustrates an auditor's report expressing an opinion on a company's liabilities for unpaid losses and loss-adjustment expenses and the schedule of liabilities for unpaid losses and loss-adjustment expenses that would accompany the report.

8.39 The procedures performed to issue an opinion on the liabilities for unpaid losses and loss-adjustment expenses may be more extensive than those required for testing those accounts as part of an audit of the basic financial statements. Any such additional procedures are generally completed in conjunction with the general audit. Accordingly, an opinion on the liabilities for unpaid losses and loss-adjustment expenses ordinarily should have the same date as the report on the basic financial statements.

8.40 Because of the nature and significance of the liabilities for unpaid losses and loss-adjustment expenses in an insurance company, the form of opinion that is expressed on the liabilities for unpaid losses and loss-adjustment expenses generally should be consistent with the opinion expressed on the audited financial statements. For example, if the report on the liabilities for unpaid losses and loss-adjustment expenses was qualified, the report on the audited financial statements should also be qualified.

8.41 Changes in estimates that are disclosed in the financial statements on which the auditor has reported should also be disclosed in the notes to the schedule of liabilities for unpaid losses and unpaid loss-adjustment expenses accompanying the auditor's special report. (See APB Opinion No. 20, *Accounting Changes*, paragraph 33.)

Exhibit 8.1

Special Report on Loss Reserves[2]

Independent Auditor's Report

Board of Directors
X Insurance Company

We are members of the American Institute of Certified Public Accountants (AICPA) and are the independent public accountants of X Insurance Company. We acknowledge our responsibility under the AICPA's Code of Professional Conduct to undertake only those engagements which we can complete with professional competence.

We have audited the financial statements prepared in conformity with accounting principles generally accepted in the United States of America [or prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of _______________] of X Insurance Company as of December 31, 20X0, and have issued our report thereon dated March 1, 20X1. In the course of our audit, we have audited the estimated liabilities for unpaid losses and unpaid loss adjustment expenses of X Insurance Company as of December 31, 20X0, as set forth in the accompanying schedule including consideration of the assumptions and methods relating to the estimation of such liabilities.

In our opinion, the accompanying schedule presents fairly, in all material respects, the estimated unpaid losses and unpaid loss adjustment expenses of X Insurance Company that could be reasonably estimated at December 31, 20X0, in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of _______________ on a basis consistent with that of the preceding year.

This report is intended solely for the information and use of regulatory agencies and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

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[2] If a significant period of time has elapsed between the date of the report on the financial statements and the date he is reporting on the loss and loss adjustment expense reserves, the auditor may wish to include the following paragraph after the opinion paragraph: Because we have not audited any financial statements of X Insurance Company as of any date or for any period subsequent to December 31, 20X0, we have no knowledge of the effects, if any, on the liability for unpaid losses and unpaid loss adjustment expenses of events that may have occurred subsequent to the date of our audit.

X Insurance Company
Schedule of Liabilities for Losses and Loss Adjustment Expenses
December 31, 20X0

Liability for losses	$XX,XXX,XXX
Liability for loss-adjustment expenses	X,XXX,XXX
Total	$XX,XXX,XXX

Note 1—Basis of presentation

The above schedule has been prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of ______________ . [*Significant differences between statutory practices and generally accepted accounting principles for the calculation of the above amounts should be described but the monetary effect of any such differences need not be stated.*]

Losses and loss adjustment expenses are provided for when incurred in accordance with the applicable requirements of the insurance laws [*and/or regulations*] of the State of ______________. Such provisions include (1) individual case estimates for reported losses, (2) estimates received from other insurers with respect to reinsurance assumed, (3) estimates for unreported losses based on past experience modified for current trends, and (4) estimates of expenses for investigating and settling claims.

Note 2—Reinsurance

The Company reinsures certain portions of its liability insurance coverages to limit the amount of loss on individual claims and purchases catastrophe insurance to protect against aggregate single occurrence losses. Certain portions of property insurance are reinsured on a quota share basis.

The liability for losses and the liability for loss adjustment expenses were reduced by $XXX,XXX and $XXX,XXX, respectively, for reinsurance ceded to other companies. Contingent liability exists with respect to reinsurance which would become an actual liability in the event the reinsuring companies, or any of them, might be unable to meet their obligations to the Company under existing reinsurance agreements.

Appendix A

Auditing

Audit Objectives

SAS No. 57, *Auditing Accounting Estimates*, states that the auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that—

a. All accounting estimates that could be material to the financial statements have been developed.

b. Those accounting estimates are reasonable in the circumstances.

c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

When auditing a property/liability insurance company, the auditor is primarily concerned with obtaining sufficient competent evidential matter to support the assertions inherent in a company's financial statements. SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter, describes the relationship between assertions embodied in the financial statements, audit objectives, and substantive audit procedures.

Audit Planning

In planning the audit, the auditor should obtain a thorough understanding of the company's overall operations including its claim reserving and payment practices. In addition, the auditor should obtain or update his or her knowledge of the entity's business and the various economic, financial, and organizational conditions that create risks for companies in the insurance industry.

The auditor performing or supervising the audit of loss reserves should have knowledge about loss reserving including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of the appropriate methods available for calculating loss reserves. Knowledge about loss reserving is ordinarily obtained through experience, training courses, and by consulting sources such as industry publications, textbooks, periodicals, and individuals knowledgeable about loss reserving. As stated in chapter 4 of this guide, if the auditor is not a loss reserve specialist, he or she should use the work of an outside loss reserve specialist in the audit. The auditor should obtain a level of knowledge about loss reserving that would enable him or her to understand the methods or assumptions used by the specialist.

Ordinarily, audit procedures performed to obtain sufficient evidence to support assertions about loss reserves are time consuming and may be performed most efficiently when initiated early in the fieldwork.

The auditor should determine that all loss reserve components, all lines of business, and all accident years that could be material to the financial statements have been considered in developing the overall reserve estimate. The components of loss reserves are described in chapter 4 of this guide.

The estimate of loss reserves will frequently affect other accounting estimates contained in the financial statements. The auditor should evaluate accounting estimates for such items as contingent commissions, retrospective premium adjustments, policyholder dividends, recoverability of deferred acquisition costs, premium deficiencies, state assessments based on losses paid, minimum statutory reserves, and the liability or allowance for unauthorized or uncollectible reinsurance.

Audit Risk and Materiality

Audit risk and materiality are the key criteria in determining the nature, timing, and extent of audit procedures to be performed and in evaluating whether the financial statements taken as a whole are presented fairly. Considerations of audit risk and materiality should be addressed in the planning stage of an audit and should be used to develop and support an audit approach. For most insurance companies, the largest liability on the balance sheet is loss reserves, and the largest expense on the income statement is incurred losses; therefore, both are material to the financial statements. In addition, loss reserve estimates are based on subjective judgments and, therefore, involve a high level of inherent risk. For these reasons, loss reserves typically are the area with the highest audit risk in a property and liability insurance entity.

SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312),* provides guidance on audit risk and materiality as they relate to planning and performing an audit. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person relying on the financial statements. Some factors to be considered in establishing materiality levels for estimates such as loss reserves are the company's operating results and the company's financial position. The auditor should also consider the measurement bases that external financial statement users will focus on when making decisions.

SAS No. 47* states that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are material to the financial statements are detected. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides specific guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud.

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* Statement on Auditing Standards (SAS) No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU secs. 312, 329, 339, and 341), among other matters, amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* to add a requirement to SAS No. 47 to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted. This chapter of the Guide will be modified in a future edition of the Guide to reflect the requirements and terminology used in SAS No. 96.

SAS No. 82[*] requires the auditor to assess the risk of material misstatement due to fraud and consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (*a*) misstatements arising from fraudulent financial reporting and (*b*) misstatements arising from misappropriation of assets in the following categories:

Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

Misappropriation of Assets

- Susceptibility of assets to misappropriation
- Controls

In addition to requiring the auditor to assess the risk of material misstatement due to fraud, SAS No. 82 provides guidance on how the auditor responds to the results of that assessment, provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud, describes related documentation requirements, and provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

SAS No. 47 defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect. SAS No. 47 states that audit risk consists of three components:

1. *Inherent risk* is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related balances or classes than for others. In addition to those factors that are peculiar to a specific assertion for an account balance or class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. Loss reserves generally are based on subjective judgments about the occurrence of certain events that have not yet been fully reported, developing trends, and the outcome of future events. Due to the subjectivity and inherent imprecision involved in making such judgments, estimating loss reserves requires considerable analytical ability and an extensive understanding of the business.

2. *Control risk* is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's controls. That risk is a function of the effectiveness of the design and operation of controls in achieving the entity's broad control objectives relevant to an audit of the entity's financial statements.

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[*] The AICPA has issued an exposure draft of a proposed SAS titled *Consideration of Fraud in a Financial Statement Audit*. This proposed SAS would supersede SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and amend SAS No. 1, section 230, *Due Professional Care in the Performance of Work*. A final standard is expected to be issued during the fourth quarter of 2002. Readers should be alert to any final pronouncement.

Some control risk will always exist because of the inherent limitations of internal control. The degree of control risk associated with significant accounting estimates is usually greater than the risk for other accounting processes because accounting estimates involve a greater degree of subjectivity, are less susceptible to control, and are more subject to management influence. It is difficult to establish controls over errors in assumptions or estimates of the future outcome of events in the same way that controls can be established over the routine accounting for completed transactions. In addition, there is a potential for management to be biased about their assumptions; accordingly, a high level of professional skepticism should be exercised by the auditor. The likelihood that loss reserve estimates will contain misstatements of audit importance can be reduced by using competent people in the estimation process and by implementing practices to enhance the reasonableness of estimates, such as requiring that persons making the estimates retain documented explanations and other support for assumptions and methodologies used, and perform retrospective tests of past performance.

3. *Detection risk* is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he or she were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Due to the relatively high inherent and control risk associated with loss reserves, detection risk is significant in the audit of loss reserves but may be mitigated by adequate planning, supervision, and conduct of the audit. Adequate planning should identify the existing inherent and control risk factors so that they may be adequately addressed in the audit.

This appendix identifies some of the matters that may influence audit risk in an audit of the financial statements of a property and liability insurance company. It emphasizes matters relevant to the premium cycle, the claims cycle, and the investment cycle.

Premium Cycle

- *Premiums*
  - Principal lines of business written (property or liability, commercial or personal, and so on)
  - Geographic, product, or other concentrations
  - Rate-making environment and policies or practices
  - Changes in product mix or emphasis
  - Extent of retrospectively rated or reporting-form business and the estimability and timeliness of retrospective revenue or expense determinations

- — Unusual, erratic, or substantial changes in premiums in force
- — Propriety of premium revenue-recognition methods used
- — Evidence or expectations of increased competition, market saturation, or declining demand
- — Significant accounting procedures performed at other locations, such as branch offices versus the home office
- — Principles and policies used by the company in recognition of premiums
- — Statistical coding system used to support underwriting functions

- *Receivables*
  - — Suspense-account activity and condition (for example, large or old uncleared items or numerous outstanding debt and credit items)
  - — Agent statement terms and financing arrangements (for example, extended credit terms, expense supplements, loans, and profit-sharing arrangements)
  - — Agency concentration (for example, significant volume from limited numbers of agents)
  - — Agency profitability (for example, derivation of substantial unprofitable business from particular agents)
  - — Nonadmitted asset trends (for example, sizable past-due or uncleared balances)
  - — Commission arrangements (for example, contingent commissions, or unusual commission structures that may encourage agent fraud)
  - — Agent-binding authorities to accept underwriting risks or settle claims without prior approval
  - — Agent commingling of insurer/insured funds collected in a fiduciary capacity (for example, use of third-party funds for operating or personal purposes)
  - — Reasonableness of estimates for earned but unbilled premiums
  - — Adequacy of premium installment payments to provide sufficient protection in the event of policy cancellation
- *Deferred policy-acquisition costs*
  - — Nature of costs deferred, particularly those that vary indirectly with new business written
  - — Frequency and adequacy of recoverability (premium deficiency) tests, particularly regarding line of business groupings and estimated loss-ratio projections
- *Reinsurance*
  - — Changes in risk-retention levels, including catastrophic loss coverage
  - — Financial responsibility, and stability of ceding or assuming reinsurers, intermediaries, "fronting" companies, pools and syndicates, and so on
  - — Reliability, adequacy, and timeliness of financial reporting, particularly in the case of reinsurance assumed
  - — Business purpose of the reinsurance transactions

Loss Reserves and Claims Cycle

- A company's product mix may have a significant effect on the variability of loss reserves. It is more difficult to estimate loss reserves for long-tail lines of business than it is to estimate reserves for short-tail lines of business because events affecting ultimate claim settlement amounts will occur at a later date
- New products or new types of risks generally will add to the subjectivity of the loss reserving process because of the company's lack of experience with the new product and relative lack of relevant historical data
- Deductibles, policy limits, and the retention level of specific lines of business may have a significant effect on the volatility of losses to be settled
- Policy lines with a low frequency and high severity of claim settlements may exhibit more variability than policy lines associated with a high frequency and low severity of claim settlements
- Future inflation may result in ultimate loss settlements different from the amounts originally anticipated
- Social inflation, which arises from the legal environment, as well as recent jury awards have the potential to increase ultimate loss settlements
- The level and consistency of backlogs in processing claims affect the stability of loss reserve analyses
- The degree of management's optimism or skepticism when establishing loss reserve assumptions may lead to fluctuations in reserves
- The introduction of new policy forms may result in an unanticipated expansion of coverage. In addition, the company may lack historical data for losses under the new policy forms
- Changes in regulations may cause insurance companies to change their claims adjusting practices; for example, a change in regulations may require an increase in the waiting period before workers' compensation benefits begin, or "bad faith" claim settlement laws may alter settlement practices
- Catastrophic or unusual losses may distort historical experience. Reserves for catastrophic losses, particularly losses that occur near the end of the period, are difficult to estimate
- Insurance company cash flow considerations may result in a change in loss payment practices
- The quality and experience of personnel reviewing a company's loss reserves affect the overall control environment. For example, a company that employs a qualified actuary or an experienced loss reserve specialist to review reserves is usually better equipped to estimate loss reserves than is a company that uses a less qualified individual to perform that task
- The proper functioning of controls over claim processing will reduce the possibility of error in the data underlying loss reserve estimates. The risk of error in the claims data base will be minimized if controls are functioning as designed
- The completeness and accuracy of a company's data base will affect the risk of misstatement in assertions about loss reserves
- The accuracy and reliability of claims data received from outside sources (i.e., cedents, reinsurers, voluntary and involuntary risk pools, etc.) will also affect the risk of misstatement in assertions about loss reserves

- The adequacy of information and data produced by a company is critical in projecting loss reserves. For example, a company capable of accumulating only basic data on premium and loss experience generally poses a greater risk, all other things being equal, than does a company that is capable of accumulating and analyzing more sophisticated data
- Significant decentralization of operations and reliance on intermediaries may increase control risk
- A high level of delegation of claims processing or adjusting functions to intermediaries or outside adjusters, without adequate supervision, may result in inefficient claim handling and inappropriate case reserve estimates
- Changes in delegated responsibilities may result in changes in claims settlement patterns and thereby invalidate historical claim experience
- The quality of a company's underwriting and claims staff and its knowledge of the industry and control over the company's exposure to loss will have a significant effect on the loss reserving process
- Existing manual or computerized systems may not be able to cope with a change in the volume of claims
- Changes in the insurance company's claims processing system may invalidate the historical data used to develop and evaluate loss reserves. Types of changes that may have this result include—
  — Changes in claim classification, such as counting claimants instead of counting claims, considering reopened claims as IBNR claims rather than as development on reported claims, and changing the definition of claims closed without payment
  — Changes in settlement patterns, such as slowing down the payment of claims to increase the holding period of investable assets or speeding up the payment of claims to decrease the effects of inflation
  — Changes in case reserving methodologies, either explicit or implicit, such as a change from estimating case basis reserves on an ultimate cost basis to estimating case-basis reserves on a current cost basis
  — Changes in computerized information systems that result in faster or slower recognition and payment of claims

Investment Cycle

- Significant concentrations of credit risk with one counterparty or within one geographic area
- Significant use of derivative securities, particularly without relevant in-house expertise
- High volumes of borrowing or lending of securities
- Relatively high volatility in interest rates
- Changes in the terms of government guarantees
- Actual prepayment experience that differs significantly from that anticipated
- Declines in the values of collateral underlying securities
- Changes in guarantor's claims processing
- Significant conversion options related to the collateral (for example, variable to fixed rates)

- Sales and transfers from the held-to-maturity securities portfolio
- High volume of transactions in the available-for-sale or trading securities portfolios
- Wash sale transactions
- Uncertainty regarding the financial stability of asset-backed securities services or of guarantors
- Investment liquidity (for example, investments with terms and maturities not balanced to meet policy claim obligations)
- Investment valuation (for example, improper or inadequate valuation methods or documentation and indications of potential or likely permanent impairment)
- Investment yield trends (that is, the indicated ability to manage the investment portfolio at maximum yields commensurate with prudent risk considerations)
- Investment policy (for example, undue emphasis in speculative or high-risk investment vehicles)
- Investment restrictions (that is, degree of compliance with regulatory or self-imposed restrictions)

Acquisition Costs

- Deferral of costs that vary with and are primarily related to the production of new and renewal business
- Capitalized acquisition costs appropriately amortized in relation to premiums earned
- Capitalized costs should be recoverable in relation to anticipated loss experience, anticipated earned premiums, and other factors
- The company's accounting policy for acquisition costs consistently applied

Other

- Adequacy of premium and claim cutoff procedures at interim and annual reporting dates
- Accuracy and thoroughness of statistical coding system used for underwriting (premium, loss, and expense) analysis
- Timeliness and adequacy of reconciliation procedures, particularly in balancing accounting and statistical records, including loss-development data
- Industry experience of principal officers and employees
- Statutory compliance and solvency
- Existence and extent of related-party transactions

Appendix B

Illustrations of Auditing Objectives and Procedures

Most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning management's assertions in financial statements. Assertions are representations by management that are embodied in financial statement components. They can be either explicit or implicit and can be classified according to the following broad categories:

- *Existence or occurrence*—Whether the amounts exist at the balance sheet date and whether recorded transactions have occurred during the period
- *Completeness*—Whether all transactions and accounts that should be presented in the financial statements are included
- *Rights and obligations*—Whether assets are the rights of the company and liabilities are obligations of the company at the balance sheet date
- *Valuation and allocation*—Whether asset, liability, revenue, and expense items have been included in the financial statements at appropriate amounts
- *Presentation and disclosure*—Whether items in the financial statements are properly classified, described, and disclosed

There is not necessarily a one-to-one relationship between audit objectives and procedures. Some procedures may relate to more than one objective. On the other hand, a combination of procedures may be needed to achieve a single objective.

In selecting particular substantive tests to achieve the audit objectives that the auditor has developed, the auditor considers (1) his or her assessment of control risk, (2) the relative risk of misstatement due to error or fraud that would be material to financial statements, and (3) the expected effectiveness and efficiency of tests. These considerations include the nature or materiality of the items being tested, the kinds and competence of available evidential matter, and the nature of the audit objective to be achieved. Because of the large volume of transactions in the premium and claims cycle, audit sampling techniques—either statistical or nonstatistical—are often employed in applying certain tests.

The nature, timing, and extent of the procedures to be applied on a particular engagement are matters of professional judgment to be determined by the auditor based on the specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of the individual assertions embodied in the components of the financial statements. The combination of the auditor's assessment of control risk and results of substantive tests should provide a reasonable basis for the auditor's opinion.

These illustrations are not intended to be all-inclusive. As stated earlier, the auditor must determine procedures based on the specific circumstances. More detailed auditing issues and procedures are discussed in specific chapters of this guide.

Exhibit B-1

Premium Cycle

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Existence	● Premiums, commissions, and revenue and expense amounts recorded must relate to policies issued or in force during the period.	● Unissued policy forms are physically controlled. ● Policy applications are properly registered.	● Obtain evidence about proper issuance by— 1. Checking policy file for signed application and underwriting approval. 2. Tracing to master file data such as policy number, name, effective date, kind of policy, coverage limits, premium, payment mode, and agent. 3. Comparing premiums to cash receipts records. ● Check daily reports for underwriting approval, calculation of premiums and commissions, and proper recording of premium payments. ● Reconcile premiums and commissions to agents' reports. ● Trace selected premiums transactions to premium register to check that policy terms, lines of business, and premium amounts have been properly recorded. ● Reconcile monthly summary of premiums written—direct, assumed, and ceded—and related commission with general ledger. ● Test that agents submitting applications are licensed, and inspect agency agreements.

Completeness	• Premium amounts include premiums from all policies and are accurately compiled.	• Policies are recorded on a timely basis in the detail policy records, and records are reviewed for recording of all policy numbers. • Guidelines are established for *coding* policies, and *coding* is reviewed for accuracy. • Input, output, and data center controls are maintained to ensure that all changes to detail policy records are processed properly.	• Test that premiums are recorded as described above. • Assess control over policy forms and policy issuance by— 1. Testing whether policies supplied to agents are promptly entered on policy *control* records. 2. Inspecting policy numbers issued and testing procedures for investigation of missing numbers. 3. Reconciling policy allotment register to underwriting reports of new business. 4. Testing whether daily reports are recorded before filing. • Check calculation of premiums to premium rate tables. • Compare ratios of commissions to premiums written with ratios of prior years, and investigate significant fluctuations.
	• Agents' balances include all amounts due to or from agents as of balance sheet date.	• Amounts included in commission calculations are reconciled to premiums written. • Detailed agent's accounts are reconciled to the general ledger.	• Test that premiums and commissions are recorded as described earlier. • Trace selected commission rates to commission schedules.

(Continued)

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Rights and Obligations	• Return premiums, policyholder dividends, and retroactive premium adjustments are properly recorded.	• Policy endorsements and cancellations or other changes are approved; determinations of additional or return premiums are also reviewed. • Policyholder dividends, retrospective premiums, and experience-rated premiums are reviewed and approved. • Premium adjustments are compared with policy provisions, and dividends are compared with dividend declaration for compliance.	• Test the propriety of return premiums by inspecting evidence of cancellation on policy face and by obtaining evidence about adherence to company policy regarding cancellation method. • Test that policyholder dividends comply with authorization, and reconcile amounts with underlying policy records. • Inspect transactions on periodic reporting policies to test whether periodic reports are received according to terms of policies, audits required by policies are performed, and premium deposits and additional or return premiums are properly calculated and recorded. • Inspect premiums recorded for retrospectively rated policies to test whether company procedures and policy terms have been followed in determining premiums and whether claims data have been included in the calculations.

		• Premium and loss data underlying calculations are reconciled to the records, and calculations are reviewed and approved.	
	• Reinsured policies are properly identified, and premiums on ceded reinsurance are properly recorded and reported to assuming companies.	• Risks covered by reinsurance agreements are identified, properly designated, recorded in the premium billing and in-force files, and reported to the assuming company.	• Test whether risks in excess of retention amounts are reinsured. • Test computation of reinsurance premiums and commissions; trace to reinsurance records. • Trace information from premium records to reports sent to reinsurers. • Test the propriety of reinsurance balances payable by reference to reinsurance agreements and policy records.
Valuation or Allocation	• Premium revenues and unearned premium reserve are recorded properly.	• Premium register is balanced periodically to update premiums in force. • Premiums written are recorded in the general ledger and are reconciled periodically to premiums entered in statistical records and the premium register • Return premiums are reviewed for reasonableness by comparison to original premiums.	• Inquire about the method for recognizing premium revenue and determining unearned premium reserves; check consistency of its application with prior years. • Inspect recording of unearned premium reserves by reconciling additions and deletions in force for selected periods back to original documentation and by checking calculation of unearned premiums. • Test that the unearned premium reserves are correctly reduced for ceded insurance.

(Continued)

Premium Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
	• Uncollectible agents' balances are identified and accounted for.	• Agents' balances are periodically aged in conformity with statutory requirements.	• Compare aged trial balance of agent's balances with similar trial balances of previous periods, and investigate significant fluctuations. • Test collectibility by inspecting subsequent collections or by inspecting history of receipts. • Evaluate the adequacy of the allowance for doubtful accounts, including suspense items.
		• Delinquent accounts are investigated and write-offs of bad debts and unreconciled items are approved. • Advances to agents are approved in accordance with company procedures. • Statements of transactions and balances are periodically sent to agents.	• Test whether agents' balances considered to be nonadmitted assets were properly excluded from the statutory statements and included in the GAAP statements only to the extent deemed collectible.
	• Acquisition costs are properly capitalized and amortized.	• Deferrable costs are properly capitalized and amortized. • Amortization of deferred costs is compared for consistency with premium recognition.	• Inspect documentation of procedures for recording acquisition costs. • Inspect the support for deferred acquisition costs. • Test whether acquisition costs are properly capitalized and amortized on a consistent basis. Also test whether the balance at year-end is reasonably expected to be recovered.

Claims Cycle

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Existence or Occurrence	● Paid claims relate to transactions during the period, and unpaid claims are recorded as of the balance sheet date.	● Initial entry of claims data is appropriately controlled. ● Claims are checked against daily reports for existence of coverage. ● Proper documentation and proof of loss are obtained before payment. ● Salvage and subrogation are noted in claims files and are followed up. ● Supporting data for claims and compliance with company policies are reviewed before approval of claim payments.	● For selected paid claims, inspect documentation of loss payments for approval and inspect canceled checks or drafts for proof of payments. ● Inspect documentation of selected paid claims supporting relevant accounting and statistical data, such as amounts, incurred dates, and coding. ● For selected unpaid claims (case-basis files), inspect documentation supporting relevant accounting data (such as amounts of reserves shown in the outstanding claims listing).

(Continued)

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Completeness	● Records include all claims paid during the period and all reported claims unpaid as of the balance sheet date.	● Procedures are in effect to ensure that claims and related information are promptly reported to the claims department.	● Reconcile paid claims to the general ledger and appropriate subsidiary ledger and statistical records. ● Select open claims (including reopened claims) from the files and test whether they are properly accounted for on the outstanding claims listing.
		● Prenumbered claim files are used or sequential claim numbers are assigned. ● Appropriate controls of input, output, and other data are maintained to ensure that all claims are processed. ● Detailed control records are maintained for all reported claims.	● Reconcile unpaid claims (case basis) to the general ledger and appropriate subsidiary ledger and statistical records. Reconcile unpaid claim files to inventory. ● Test whether claim processing cutoff at balance sheet date was proper and consistent with prior year. ● From paid-loss transactions and the trial balance or master file of outstanding claims, test accumulation of data and balances by line of business and by accident or exposure period. ● For selected claim files closed without payment, test whether they have been properly closed.

		• Statistical data are periodically reconciled to detail records. • Inventory of unpaid claims files is periodically reconciled to the master file for errors or omissions.	
Rights and Obligations	• Reserves and related balances under reinsurance assumed are properly recorded.	• Current information is maintained on the status of assumed and ceded reinsurance contracts • For facultative reinsurance, reported claims are reviewed for notification of the reinsurer. • For treaty reinsurance, reinsurance recoverable estimates are recorded on a reinsurance bordereau, which is forwarded to the reinsurer in accordance with contract terms.	• Review abstracts of significant reinsurance agreements. • Trace relevant accounting data to reports provided by ceding companies. • For significant treaties or groupings of treaties, obtain or prepare a development of losses. • Evaluate whether the IBNR reserve includes adequate provision of IBNR claims under reinsurance agreements.
	• Reinsurance recoverable on paid and unpaid losses is properly recorded.	• Reinsurance recoverable is regularly reconciled to detailed records. • Claims are reviewed for applicability of reinsurance, and the reinsurers are promptly notified. • Reinsurers are promptly billed as claims are paid. • Paid claims are accumulated for recoveries under excess contracts.	• Reconcile summary of reinsurance recoverable to general ledger. • Confirm selected balances with reinsurers. • Evaluate whether loss reserves have been properly reduced for reinsurance contracts. • Trace relevant accounting data to reports provided to assuming companies. • Review Schedule F, "Assumed and Ceded Reinsurance," of the annual statement, and investigate significant or unusual items.

(Continued)

Claims Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
	● Liability for outstanding drafts is properly recorded.		● Obtain a list of the unpaid drafts account as of the balance sheet date and reconcile to general ledger. ● On a test basis, trace draft payments subsequent to balance sheet date back to list. ● Agree prepaid drafts to paid drafts on a test basis, and test unpaid claims to list. ● Review supporting documents for material drafts that have been outstanding for an unreasonable length of time.
Valuation or Allocation	● Paid losses and related accounts are recorded in the proper amounts. ● Estimates of loss reserves are reasonable.	● Outstanding loss reserves are balanced to monthly claims activity. ● Changes in outstanding loss reserves are promptly reviewed and recorded. ● For case-basis reserves, open claim files, including previous estimates of unpaid claims, are regularly reviewed and analyzed for adequacy of reserves in light of current information.	● Test posting of losses paid, loss-adjustment expenses paid, and reinsurance recoverable for claim selected from claim register; reconcile to subsidiary registers and statistical records. ● Reconcile the total amount of paid losses to cash disbursement records. ● Test loss-reserve development by line of business. ● Perform analytical procedures on losses incurred, losses paid, loss reserves, and loss ratios by line of business. ● Review current reports of state insurance examiners and loss developments prepared for the annual statements and Schedule P, and investigate significant items.

• Appropriate officials regularly develop and analyze reserves for each line of business by accident year or by other appropriate basis. Development and analysis includes IBNR claims, claims adjustment expenses, and reserves on reinsurance assumed. • Factors and assumptions used in estimating loss reserves are documented and periodically reviewed for reasonableness.	• Obtain evidence about the company's method of determining the reserve for IBNR losses and evaluate its reasonableness. Determine if there have been any significant changes in the company's methods and procedures, and evaluate the effect of all current trends and conditions. • Compare current IBNR reserve against claims reported in subsequent period, and investigate significant fluctuations. • Compare company's IBNR loss-reserve development for prior periods with actual results, and investigate causes of significant discrepancies. • Consider the use of an actuary.

Investment Cycle[1]

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
Existence	• Securities and investment assets included in the balance sheet physically exist.	• Transactions settled after year-end are reviewed for recording in the proper period (as of the trade date). • Custodial function is independent of investment and accounting functions and provides security commensurate with the risks involved. • Securities and evidence of ownership held by the company are kept in vault with access limited to authorized personnel.	• Inspect and count the securities held on the client's premises as of the date that the securities amounts are reconciled to the general ledger control accounts. • Obtain confirmations from the custodians of securities held for the client. Compare the confirmed lists with the trial balance and investigate discrepancies. • Obtain confirmations that securities purchased under repurchase agreements but not delivered are being held by the sellers or the sellers' custodian on the company's behalf. • Confirm with brokers the status of securities in transit. • Compare the face amounts or number of shares and the cost of investments recorded in the investment ledger with forms and documents created at the time of purchase. Examine forms and documents for proper completion and authorization.

[1] SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investment in Securities*, provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities. In addition, the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing SAS No. 92. Practitioners should refer to SAS No. 92 and its companion Audit Guide for guidance on audit objectives, control activities and techniques, and auditing procedures.

		● Reports and confirmations of securities held by outside custodians are reconciled to company records. ● Financial responsibility and capability of outside custodians are periodically reviewed.	● Obtain and read custodial agreements and available reports regarding the adequacy of the custodians' internal controls and financial stability.
Completeness	● Investment assets include all investments of the company.	● Buy and sell orders to brokers are compared to brokers' advices.	● Inspect and count securities held by the client. Obtain confirmation from custodian of securities held for the account of the client.
	● Investment amounts include all transactions during the period.	● Authorized lists of signatures, brokers, and so forth are maintained.	● Read finance committee minutes and test whether investment transactions have been properly authorized. ● Determine that only securities dealers approved by the finance committee are used.
		● Written policy statements detailing investment guidelines and limitations are prepared by designated levels of management.	● Compare investment yields during the period with expected yields based on previous results and current market trends; investigate significant discrepancies.
		● Potential investment transactions are reviewed by an investment advisory committee and approved by a finance committee. ● Questions concerning compliance with regulatory restrictions are referred to the legal department before transactions are executed.	● Test transactions settled after the end of the period for recording in the proper period (as of the trade date).

(Continued)

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
	• Investment records are properly compiled, and totals are properly included in the investment accounts.	• Recorded amounts of investments are periodically compared to safekeeping ledgers and to current market values.	• Examine input and output data and balances in individual investment accounts to test whether transactions are properly recorded. • Compare investment totals to the client's reconciliation of the investment ledger to the general ledger control accounts. Investigate significant discrepancies and any large or unusual reconciling items.
		• Batch balancing, logging, and cash totals are used to provide assurance that all purchases and sales have been properly posted to master files.	
Rights and Obligations	• The company has legal title or similar rights of ownership.	• Securities and other evidence of ownership are in the company's name.	• Review legal department compliance records concerning statutory requirements and limitations. • Examine securities to determine whether they are registered or payable to the company, an authorized nominee, or the bearer. • Examine bonds to determine whether interest coupons due after the count date are attached.

Valuation or Allocation	● Investments are recorded at their proper amounts.	● Securities for which there is no active market are monitored for valuation at cost and are written down to market value when required. ● Interim securities valuations are obtained from outside brokers. ● Valuations for statutory reporting purposes are reviewed for conformity with NAIC published values. ● Market prices for purchases and sales are compared with independent sources.	● Compare recorded costs of investments to published market quotations at trade date. Consider reasonableness of commission rates, taxes, and so on. ● Compare recorded market values of investments to published market quotations at the end of the period. ● Examine summaries of interest, dividend, and principal payments for indication of security value impairment. ● Examine past-due bonds and notes for endorsements or evidence of reductions in principal through receipt of partial payments.
	● Investment income and losses are recorded in the proper amounts.	● Unrealized gains and losses are substantiated by reconciliation with prior values. ● Adjustments of investment accounts are reviewed and approved by an authorized official.	● Test determination of interest earned, accrued interest receivable, and amortization of discount or premium. ● Test dividend income by reference to published dividend records. ● Test computations of realized gains and losses by appropriate cost method. ● Obtain financial reports of joint ventures or managed real estate and compare reported amounts of dividends, net rentals, and so on, to the records.

(Continued)

Investment Cycle—continued

Financial Statement Assertions	*Audit Objectives*	*Examples of Selected Control Activities and Techniques*	*Examples of Auditing Procedures*
		• Interest and dividends are reviewed for accuracy by reference to reliable sources. • Income amounts are compared to cash receipts records and are reconciled to the bond and stock master listings. • Interest and dividends due but not received are reconciled to estimated and paid income lists.	• Review purchases and sales for indications of possible wash sales.
Presentation and Disclosure	• Investments are properly classified and disclosed.	• Realized capital gains and losses are properly recorded and classified. They are then submitted on a timely basis to the tax department.	• Test whether disclosures comply with GAAP. • Inquire about pledging, assignment, or other restrictions. • Read finance committee minutes. • Examine loan agreements.

Appendix C

Illustrative Financial Statements and Disclosures

Introduction

1. This appendix illustrates financial statements of a nonpublic property and liability insurance company and the accompanying disclosures that are unique to such companies. Disclosures concerning the company's pension plans, postretirement benefits other than pensions, stock options, lease commitments, long-term debt, extraordinary items, segments, accounting changes, derivative instruments, hedging activities, and other items that are not unique to property and liability insurance companies have been omitted for purposes of this guide. The format presented and the wording of the accompanying notes are only illustrative and are not necessarily the only possible presentations.

2. Except for the treatment of gains and losses described in FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, insurance companies that are SEC registrants should follow Article 7 of SEC Regulation S-X, which prescribes the form and content of financial statements. Also, the SEC's Financial Reporting Release (FRR) No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters* requires property and liability insurance companies to disclose in financial statements filed with the SEC certain information concerning reserves for unpaid claims and claim adjustment expenses. The Exchange Act requires certain supplementary information with respect to quarterly financial data. Other SEC regulations also require additional disclosures (for example, details with respect to deferred acquisition costs).

3. GASB Statement No. 10, *Accounting and Financial Reporting for Risk Financing and Related Insurance Issues*, as amended and interpreted by various GASB pronouncements,* requires public entity risk pools to present additional information beyond these illustrative financial statements. This additional information includes reporting assessments receivable from pool participants for premium deficiencies, disclosures about revenues collected in anticipation of future catastrophe losses, the aggregate outstanding amount of claims outstanding that have been settled through the purchase of annuity contracts, and the pool risk transfer agreement. Also, outstanding claims by

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* The Governmental Accounting Standards Board (GASB) has issued GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. That Statement fundamentally changes the format and content of financial statements for all state and local governmental entities, including public entity risk pools, and becomes effective in three phases depending on an entity's total annual revenues (as specifically defined) in the first fiscal year ending after June 15, 1999. The first implementation phase is for financial statements for periods beginning after June 15, 2001, the second implementation phase is for financial statements for periods beginning after June 15, 2002, and the third implementation phase is for financial statements for periods beginning after June 15, 2003. For all phases, earlier application is encouraged. Special transition provisions apply for component units.

kind of contract and ten-year claims development information on a policy-year basis should be presented as required supplementary information.

4. These illustrative financial statements are not intended to include items that should be accounted for under the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* and do not reflect the requirements of FASB Statement No. 133. Practitioners should refer to FASB Statement No. 133 for guidance on reporting derivative instruments and hedging activities.

Exhibit C-1

The Property and Liability Insurance Company and Subsidiaries

Consolidated Balance Sheets
December 31, 20X2 and 20X1
(Dollars in thousands)

ASSETS	*20X2*	*20X1*
Investments (notes 1 and 2):		
Trading securities	$ 11,683	$ 11,259
Securities available for sale	1,006,279	953,507
Securities held to maturity	280,387	270,208
Mortgage loans on real estate (less allowance for credit losses, 20X2—$2,300; 20X1—$2,070)	472,509	398,426
Real estate, net of accumulated depreciation (20X2—$12,921; 20X1—$12,774) and less allowance for impairment of value (20X2—$1,173; 20X1—$1,150)	31,905	30,028
Total investments	1,802,763	1,663,428
Cash and cash equivalents	31,564	28,357
Accrued interest and dividends	31,358	27,568
Premium and agents' balances*	55,295	56,212
Prepaid reinsurance premiums	21,345	18,739
Reinsurance receivables, net of uncollectible amounts	27,908	24,461
Deferred policy acquisition costs (note 1)	168,974	154,941
Property and equipment, at cost, less accumulated depreciation of $17,837 in 20X2 and $15,404 in 20X1 (note 1)	34,443	27,938
Other assets	128,577	107,378
TOTAL ASSETS	$2,302,227	$2,109,022

See accompanying notes to consolidated financial statements.

* SOP 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, requires, among other things, that the summary of significant accounting policies include the basis for accounting for trade receivables, and the classification and method of accounting for other receivables. Receivables for property and liability companies include, but are not limited to, mortgage loans, agents' balances, premiums receivable, workers' compensation deductible recoveries, reinsurance recoverables, and securities on deposit with state insurance departments (which require financial statement disclosure). SOP 01-6 requires that a description of the accounting policies and methodology the entity used to estimate its allowance for doubtful accounts be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment and may also include discussion of risk elements relevant to particular categories of financial instruments. In addition, SOP 01-6 requires that the summary of significant accounting policies include the policy for charging off uncollectible trade receivables.

SOP 01-6 contains other presentation and disclosure requirements that may apply to the financial statements of insurance entities. Readers should refer to the full text of SOP 01-6. All of the disclosure requirements of SOP 01-6 are not presented in these illustrative financial statements.

LIABILITIES	20X2	20X1
Losses and loss-adjustment expenses (note 1)	$1,183,343	$1,030,345
Unearned premiums (note 1)	493,833	482,619
Dividends to policyholders	3,087	4,042
Reinsurance funds withheld and balances payable	15,727	35,584
Accrued expenses	85,780	82,608
Federal income taxes payable (notes 1 and 5)	3,166	7,058
Deferred income taxes (notes 1 and 5)	34,084	35,133
Other liabilities	56,144	43,782
Total liabilities	1,875,164	1,721,171
Commitments and contingencies (Note 10)		
SHAREHOLDERS' EQUITY (note 7)		
Common stock ($5 par value authorized—11,500 shares; issued—2,500 shares, including 200 shares in treasury in 20X2 and 20X1)	12,500	12,500
Paid-in capital	22,500	22,500
Retained earnings (notes 6 and 7)	390,815	351,521
Accumulated other comprehensive income:		
Net unrealized appreciation on securities available-for-sale, net of deferred income taxes (20X2—$3,095; 20X1—$3,139)	5,748	5,830
Less treasury stock, at cost	(4,500)	(4,500)
Total shareholders' equity	427,063	387,851
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$2,302,227	$2,109,022

See accompanying notes to consolidated financial statements.

Exhibit C-2

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Income
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands, except per share amounts)

REVENUES	*20X2*	*20X1*
Premiums earned	$656,517	$603,461
Premiums ceded	(85,632)	(78,715)
Net premiums earned (notes 1 and 3)	570,885	524,746
Net investment income	146,683	130,070
Net realized gains and losses on securities available for sale (note 1)	84,776	32,272
Other	13,288	8,784
Total revenues	815,632	695,872
EXPENSES		
Losses and loss-adjustment expenses (notes 1 and 3)	509,568	432,413
Policyholder dividends (note 1)	4,833	7,395
Policy acquisition and other underwriting expenses (note 1)	211,239	185,834
Other	8,347	2,215
Total expenses	733,987	627,857
Income before income taxes	81,645	68,015
Provision (benefit) for income taxes (note 5)		
Current	26,108	16,291
Deferred	(1,007)	881
Total income taxes	25,101	17,172
NET INCOME	$ 56,544	$ 50,843
Net income per common share	$ 24.58	$ 22.10

See accompanying notes to consolidated financial statements.

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Comprehensive Income
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands)

	20X2	*20X1*
Net income	$ 56,544	$ 50,843
Other comprehensive income, net of tax:		
Unrealized holding gains on available-for-sale securities, net of tax expense of $29,627 and $12,312 in 20X2 and 20X1, respectively	55,022	22,865
Reclassification adjustments for amounts included in net income, net of tax expense of $(29, 671) and $(11,295) in 20X2 and 20X1, respectively	(55,104)	(20,977)
Comprehensive income	$ 56,462	$ 52,731

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Changes in Stockholders' Equity
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands)

	Common Stock			*Accumulated Other*			*Total*
	Shares	*Amount*	*Paid-in Capital*	*Comprehensive Income (Loss)*	*Retained Earnings*	*Treasury Stock*	*Shareholders' Equity*
Balance at January 1, 20X1	2,500	$ 12,500	$ 22,500	$ 3,942	$ 315,678		$ 354,620
19X1							
Net income					50,843		50,843
Dividends ($6.00 per share)					(15,000)		(15,000)
Other comprehensive income (loss)				1,888			1,888
Purchase of 200 shares of treasury stock						(4,500)	(4,500)
Balance at December 31, 20X1	2,500	$ 12,500	$ 22,500	$ 5,830	$ 351,521	$ (4,500)	$ 387,851
19X2							
Net income					56,544		56,544
Dividends ($7.50 per share)					(17,250)		(17,250)
Other comprehensive income (loss)				(82)			(82)
Balance at December 31, 20X2	2,500	$ 12,500	$ 22,500	$ 5,748	$ 390,815	$ (4,500)	$ 427,063

See accompanying notes to consolidated financial statements.

Exhibit C-4

The Property and Liability Insurance Company and Subsidiaries

Consolidated Statements of Cash Flow
For the Years Ended December 31, 20X2 and 20X1
(Dollars in thousands)

	20X2	*20X1*
Cash flows from operating activities:		
Premiums collected	$ 580,862	$ 536,532
Losses and loss adjustment expenses paid	(356,570)	(352,411)
Underwriting expenses paid	(208,067)	(184,006)
Net realized gains on available-for-sale securities	142,893	126,860
Net (increase) decrease in trading securities	(424)	1,095
Income taxes paid	(30,000)	(21,300)
Miscellaneous receipts (payments)	(45,701)	25,171
Net cash provided by operating activities	82,993	131,941
Cash flows from investing activities:		
Purchases of available-for-sale securities	(656,359)	(274,756)
Proceeds from sales of available-for-sale securities	590,644	195,826
Purchases of held-to-maturity securities	(49,826)	(176,871)
Proceeds from maturities of held-to-maturity securities	60,005	146,080
Purchase of property and equipment	(7,000)	(2,356)
Net cash used in investing activities	(62,536)	(112,077)
Cash flows from financing activities:		
Payment of dividends	(17,250)	(15,000)
Purchase of treasury shares	—	(4,500)
Net cash used in financing activities	(17,250)	(19,500)
Net increase (decrease) in cash	3,207	364
Cash and cash equivalents at beginning of year	28,357	27,993
Cash and cash equivalents at end of year	$ 31,564	$ 28,357

Reconciliation of net income to net cash provided by operating activities

	20X2	20X1
Net income	56,544	50,843
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	2,580	2,389
Gains on sales of investment	(84,776)	(32,272)
Increase in accrued interest and dividends	(3,790)	(2,983)
Increase in premium and agents' balances	917	(718)
Increase in prepaid reinsurance premiums	(2,606)	(1,953)
Increase in reinsurance receivable	(3,447)	(892)
Increase in deferred policy acquisition costs	(14,033)	(10,963)
Increase in unpaid losses and loss adjustment expenses	152,998	112,991
Increase in unearned premiums	11,214	9,816
Decrease in dividends payable	(955)	(820)
Decrease in reinsurance funds withheld	(19,857)	(18,152)
Increase in accrued expenses	3,172	2,915
Decrease in income taxes	(4,941)	(3,156)
Decrease (increase) in other—net	(10,027)	24,896
Net cash provided by operating activities	$ 82,993	$131,941

See accompanying notes to consolidated financial statements.

Exhibit C-5

The Property and Liability Insurance Company and Subsidiaries

Notes to Consolidated Financial Statements
For the Years Ended December 31, 20X2 and 20X1

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations: The Property and Liability Insurance Company and subsidiaries (the Company) is a nonpublic insurance organization providing property and liability coverage to both domestic and foreign markets. The Company is principally involved in writing insurance for domestic commercial lines.

The significant accounting policies followed by the Company are summarized as follows:

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Principles of Consolidation: The consolidated financial statements include the accounts, after intercompany eliminations, of the Company and its subsidiaries.

Basis of Presentation: The accompanying financial statements have been prepared in conformity with generally accepted accounting principles that differ from statutory accounting practices prescribed or permitted for insurance companies by regulatory authorities.

Trading Securities: Bonds, notes, and redeemable and non-redeemable preferred stock held principally for resale in the near term are classified as trading securities and recorded at their fair values. Realized and unrealized gains and losses on trading securities are included in other income.

Securities Held to Maturity: Bonds, notes, and redeemable and non-redeemable preferred stock for which the insurance company has the intent and ability to hold to maturity are reported at amortized cost, adjusted for amortization of premiums or discounts and other-than-temporary declines in fair value.

Securities Available for Sale: Bonds, notes, common stock, and redeemable preferred stock not classified as either trading or held-to-maturity are reported at fair value, adjusted for other than temporary declines in fair value, with unrealized gains and losses, net of tax, reported as a net amount in other comprehensive income. Realized gains and losses are determined on the specific identification method.

Mortgage Loans on Real Estate: Reported at unpaid balances, adjusted for amortization of premium or discount, less a provision for credit losses.

Real estate: Reported at cost, less allowances for depreciation and impairment of value.

Cash Equivalents: For the purpose of presentation in the company's statements of cash flow, cash equivalents are short-term, highly liquid investments that are both (*a*) readily convertible to known amounts of cash and (*b*) so near to maturity that they present insignificant risk of changes in value due to changing interest rates.

Recognition of Premium Revenues: Property and liability premiums are generally recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future are deferred and reported as unearned premiums.

Deferred Policy Acquisition Costs: Commissions and other costs of acquiring insurance that vary with and are primarily related to the production of new and renewal business are deferred and amortized over the terms of the policies or reinsurance treaties to which they relate. Amortization in 20X2 and 20X1 was approximately $58,000,000 and $55,000,000, respectively.

Property and Equipment: Property and equipment is recorded at cost and is depreciated principally under the straight-line method over the estimated useful lives of the respective assets.

Insurance Liabilities: The liability for losses and loss-adjustment expenses includes an amount determined from loss reports and individual cases and an amount, based on past experience, for losses incurred but not reported. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided. The methods for making such estimates and for establishing the resulting liability are continually reviewed, and any adjustments are reflected in earnings currently. The reserve for losses and loss-adjustment expenses is reported net of receivables for salvage and subrogation of approximately $17,527,000 and $16,276,000 at December 31, 20X2 and 20X1, respectively.

Participating Policies: Participating business represents 6 percent of total premiums in force and premium income at December 31, 20X2, and 8 percent at December 31, 20X1. The majority of participating business is composed of workers' compensation policies. The amount of dividends to be paid on these policies is determined based on the terms of the individual policies.

Reinsurance: In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with other insurance enterprises or reinsurers. Amounts recoverable from reinsurers are estimated in a manner consistent with the reinsured policy. The amount by which the liabilities associated with the reinsured policies exceed the amounts paid for retroactive reinsurance contracts is amortized in income over the estimated remaining settlement period using the interest method. The effects of subsequent changes in estimated or actual cash flows are accounted for by adjusting the previously deferred amount to the balance that would have existed had the revised estimate been available at the inception of the reinsurance transactions, with a corresponding charge or credit to income.

Codification: In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises (Codification). The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law.

Income Taxes: Income tax provisions are based on the asset and liability method. Deferred federal income taxes have been provided for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Such differences are related principally to the deferral of policy acquisition costs and the recognition of salvage and subrogation on an accrual basis.

Income per Share of Common Stock: Income per share of common stock is based on the weighted average number of shares of common stock outstanding during each year. The effect of stock options is not material to the computation of earnings per share.

2. Earnings Per Common Share

Basic and diluted earnings per common share (EPS) are as follows:

(Thousands, except per common share data)	*Income (Numerator)*	*Shares (Denominator)*	*Per Common Share Amount*
20X2 Net income	56,544		
Income applicable to common ownership	56,544	2,300	24.58
20X1 Net income	50,843		
Income applicable to common ownership	50,843	2,300	22.10

3. Investments

In reporting disclosures about investments in securities, entities should comply primarily with the requirements of paragraphs 6, 17, 19, 20, 21, and 22 of FASB Statement No. 115 (as amended); paragraphs 47 and 48 of FASB Statement No. 60 (as amended); paragraphs 22, 23, and 28 of FASB Statement No. 91 (as amended); and appendix C of this Audit and Accounting Guide. Other disclosure requirements may also be applicable.

4. Reinsurance Activity

Substantial amounts of reinsurance are assumed, both domestic and foreign. Such reinsurance includes quota share, excess of loss, catastrophe, facultative, and other forms of reinsurance on essentially all property and casualty lines of insurance. The Company also cedes insurance to other companies and these reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities, or economic characteristics of the reinsurers to minimize its exposure to significant losses from reinsurer insolvencies. At December 31, 20X2, reinsurance receivables with a carrying value of $8 million and prepaid reinsurance premiums of $5 million were associated with a single reinsurer. The Company holds collateral under related reinsurance agreements in the form of letters of credit totaling $5 million that can be drawn on for amounts that remain unpaid for more than 120 days.

The Company limits the maximum net loss that can arise from large risks or risks in concentrated areas of exposure by reinsuring (ceding) certain levels of risks with other insurers or reinsurers, either on an automatic basis under general reinsurance contracts known as "treaties" or by negotiation on substantial individual risks. Ceded reinsurance is treated as the risk and liability of the assuming companies.

The effect of reinsurance on premiums written and earned for 20X2 and 20X1 are as follows:

(Dollars in thousands)

	20X2		*20X1*	
	Written	*Earned*	*Written*	*Earned*
Direct	$ 477,836	$457,828	$420,580	$415,369
Assumed	206,814	198,689	207,328	188,092
Ceded	(102,551)	(85,632)	(86,100)	(78,715)
Net	$ 582,099	$570,885	$541,808	$524,746

The amounts of recoveries pertaining to reinsurance contracts that were deducted from losses incurred during 20X2 and 20X1 were approximately $4,892,000 and $3,232,000, respectively.

5. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows:

(Dollars in thousands)

	20X2	*20X1*
Balance at January 1	$1,030,345	$947,890
Less reinsurance recoverables	23,728	21,275
Net Balance at January 1	1,006,617	926,615
Incurred related to:		
Current year	509,843	429,294
Prior years	(275)	3,119
Total incurred	509,568	432,413
Paid related to:		
Current year	56,015	42,315
Prior years	300,555	310,096
Total paid	356,570	352,411
Net Balance at December 31	1,159,615	1,006,617
Plus reinsurance recoverables	23,728	23,728
Balance at December 31	$1,183,343	$1,030,345

As a result of changes in estimates of insured events in prior years, the provision of claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in 20X2 and 20X1, respectively) decreased by $275 in 20X2 because of lower-than-anticipated losses on Hurricane Howard, and increased by $3,119 in 20X1 because of higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

6. Income Taxes

The U.S. Federal statutory income tax rate applicable to ordinary income is 34 percent for 20X2 and 20X1. The Company's effective federal income tax rate is less than the statutory rate due primarily to tax exempt interest, dividends-received deduction, and fresh start adjustments.

The components of the net deferred tax liability are as follows:

	(Dollars in thousands)	
	20X2	*20X1*
Deferred policy acquisition costs	$17,093	$17,298
Salvage and subrogation	12,901	11,736
Other	4,090	6,101
Deferred tax liability	$34,084	$35,135

The Company has net operating loss carryforwards for tax purposes of $35,297 and investment tax credit carryforwards of $49,396. The tax loss carryforwards (if not utilized against taxable income) and investment tax credit carryforwards expire beginning in 20XX and continuing through 20YY.

The Company paid income taxes of $30,000 in 20X2 and $21,300 in 20X1.

7. Dividends From Subsidiaries

The funding of the cash requirements of the Company (parent company) is primarily provided by cash dividends from the Company's subsidiaries. Dividends paid by the insurance subsidiaries are restricted by regulatory requirements of the domiciliary states. Generally, the maximum dividend that may be paid without prior regulatory approval is limited to the greater of 10 percent of statutory surplus (shareholders' equity on a statutory basis) or 100 percent of net investment income for the prior year. Dividends exceeding these limitations can generally be made subject to approval by various state insurance departments. The subsidiaries paid cash dividends to the Company of $24,754,000 and $22,100,000 in 20X2 and 20X1, respectively. At December 31, 20X2, the maximum dividend that may be paid to the Company in 20X3 without regulatory approval is approximately $146,000,000.

8. Statutory Net Income and Shareholders' Equity

The Company, which is domiciled in ABC State, prepares its statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the ABC state insurance department, which (state of domicile) recognizes for determining solvency under the (state of domicile) Insurance Law. The commissioner of the state of domicile Insurance Department has the right to permit other practices that may deviate from prescribed practices. Prescribed SAP are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in (state of domicile). Permitted SAP encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises (Codification).

Note: *Although the following statutory financial information is not required to be disclosed in financial statements prepared in conformity with GAAP, insurance entities sometimes include such disclosures to facilitate use of those financial statements for purposes of filing with state regulatory authorities. The second disclosure is required under SOP 01-5,* Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification.

Generally accepted accounting principles differ in certain respects from the accounting practices prescribed or permitted by insurance regulatory authorities (statutory basis). Statutory net income was approximately $35.7 million and $52.7 million in 20X2 and 20X1, respectively, and statutory shareholders' equity, including the effects of prescribed and permitted practices was approximately $347.2 million and $299.7 million at December 31, 20X2 and 20X1, respectively.

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $____ million and $____ million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was $____ million and $____ million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been $____ million and $____ million at December 31, 20X2 and 20X1, respectively.

9. Contingencies

In November ____, California voters passed Proposition 103, requiring insurers doing business in that state to roll back property/casualty premium prices to November ____ levels, less an additional 20 percent discount. Insurers challenged the constitutionality of Proposition 103, and in May ____ the California Supreme Court upheld the proposition in large part. However, the Court also ruled that the rollback provision does not apply to an insurer who demonstrates through rate filings that the rate rollback would not allow a "fair and reasonable return." The Company filed for exemption from the rate rollback for all lines affected by Proposition 103. In September ____, the California Insurance Commissioner announced that the Company would be afforded a hearing and, using different assumptions and methods than prescribed for the original filing, determined that the Company should roll back its rates and refund premiums of $19 million. The Company disagrees with the Commissioner's methods and conclusions, and no provision for potential rate rollbacks or premium refunds is reflected in the financial results.

In October ____, the Commissioner suspended the individual hearings and began a consolidated hearing, in which the Company is participating, intended to define the generic issue of the methods to be used to calculate potential rate rollbacks and analyze future rate filings. Until the generic issues are resolved in the Commissioner's consolidated hearing, there will be uncertainty as to whether the Company will ultimately be required to roll back any of its rates or refund any premiums. Management believes such rate rollbacks and premium refunds, if any, would not have a material adverse effect on the Company's financial position.

10. Concentrations of Credit Risk

At December 31, 20X2, the Company held unrated or less-than-investment grade corporate debt securities of $________ net of reserves for losses, with an aggregate market value of $________. Those holdings amounted to 6% of the Company's corporate debt securities investments and less than 3% of total assets. The holdings of less-than-investment grade securities are widely diversified and of satisfactory quality based on the Company's investment policies and credit standards. The Company also invests in mortgage loans principally involving commercial real estate. At December 31, 20X2, 20% of such mortgages ($________) involved properties located in California and Arizona. Such investments consist of first mortgage liens on completed income-producing properties, and mortgages on individual properties do not exceed $________.

11. Fair Value of Financial Instruments[1]

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

> *Cash and Short Term Investments.* For those short term instruments, the carrying amount is a reasonable estimate of fair value.
>
> *Investment in Securities.* For investments in securities, fair values are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.
>
> *Mortgage Loans on Real Estate and Policy Loans.* The fair value of mortgage loans on real estate is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences

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[1] FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities* (an amendment of FASB Statement No. 107), as amended by FASB Statement No. 133, amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria:

a. The entity is a nonpublic entity.

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, during the reporting period.

in loan characteristics. The fair value of policy loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to contract holders with similar credit ratings and the same remaining maturities.

The estimated fair values of the Company's financial instruments which are not disclosed on the face of the balance sheet or elsewhere in the notes are as follows:

	20X2		*20X1*	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Mortgage on real estate loans	$472,509	$474,163	$398,426	$401,582
Policy loans	19,862	20,974	18,623	19,953

Appendix D

Auditor's Reports

[The material that had been included in this appendix has been revised and moved to chapter 8 of the guide.]

Appendix E

NAIC Insurance Regulatory Information System (IRIS)[1]

The NAIC Insurance Regulatory Information System (IRIS) was developed to assist the state insurance departments in monitoring financial conditions of property and liability insurance companies. The system uses financial ratios to identify companies that may be having financial difficulties. Such "priority" companies can then be targeted for closer surveillance or perhaps for on-site examination.

Financial Ratios

Financial ratios can be categorized as overall ratios, profitability ratios, liquidity ratios, or reserve ratios. A brief description of each of the individual ratios and the acceptable results (based on the guidance in effect in 2001) follows.

Overall Ratios

Gross Premiums Written to Policyholders' Surplus. A company's policyholders' surplus provides a cushion for absorbing above-average losses. This ratio measures the adequacy of this cushion, net of the effects of premiums ceded to reinsurers, without the effects of premiums ceded to reinsurers. The higher the ratio, the more risk the company bears in relation to the policyholders' surplus available to absorb loss variations. This ratio is calculated by dividing net premiums written by policyholders' surplus.This ratio is calculated by dividing gross premiums written by policyholders' surplus. The results of this test should be less than 900 percent.

Net Premiums Written to Policyholders' Surplus. A company's surplus provides a cushion for absorbing above-average losses. This ratio measures the adequacy of this cushion. The higher the ratio, the more risk the company bears in relation to the surplus available to absorb loss variations. The results of this test should be less than 300 percent.

Change in Net Writings. Major increases or decreases in net premiums written indicate a lack of stability in the company's operations. A large increase in premium may signal abrupt entry into new lines of business or sales territories. In addition, such an increase in writings may indicate that the company is increasing cash inflow in order to meet loss payments. A large decrease in premiums may indicate the discontinuance of certain lines of business, scaled back writings due to large losses in certain lines, or loss of market share due to competition. The usual range for this test is an increase or decrease of less than 33 percent.

Surplus Aid to Policyholders' Surplus. The use of surplus aid reinsurance treaties may be taken as an indication that company management believes policyholders' surplus to be inadequate. In addition, the continued solvency of

[1] Using the NAIC Insurance Regulatory Information System, National Association of Insurance Commissioners, Kansas City, Kansas.

companies with a large portion of policyholders' surplus deriving from surplus aid may depend upon the continuing cooperation of the reinsurer. The usual range for the test is less than 15 percent.

Profitability Ratios

Two-Year Overall Operating Ratio. The overall operating ratio is a measure of the operating profitability of an insurance company. Over the long run, the profitability of the business is a principal determinant of the company's financial solidity and solvency. The usual range for this test is less than 100 percent.

Investment Yield. In addition to measuring one important element in profitability, the investment yield also provides an indication of the general quality of the company's investment portfolio. The usual range for this test is greater than 4.5 percent and less than 10 percent.

Change in Policyholders' Surplus. The change in policyholders' surplus is, in a sense, the ultimate measure of the improvement or deterioration of the company's financial condition during the year. The usual range for this test is from a decrease of 10 percent to an increase of 50 percent.

Liquidity Ratios

Liabilities to Liquid Assets. The ratio of total liabilities to liquid assets is a measure of the company's ability to meet the financial demands that may be placed upon it. It also provides a rough indication of the possible implications for policyholders if liquidation becomes necessary. The usual range for this test is less than 105 percent.

Gross Agents' Balances to Policyholders' Surplus. The ratio of agents' balances to policyholders' surplus measures the degree to which solvency depends on an asset that frequently cannot be realized in the event of liquidation. In addition, the ratio is reasonably effective in distinguishing between troubled and solid companies. The usual range for this test is less than 40 percent.

Reserve Ratios

One-Year Reserve Development to Policyholders' Surplus. This ratio measures the accuracy with which reserves were established one year ago. The usual range for this test is less than 20 percent.

Two-Year Reserve Development to Policyholders' Surplus. The two-year reserve development to surplus ratio is calculated in a manner similar to the calculation in the one-year reserve development test. The two-year reserve development is the sum of the current reserve for losses incurred more than two years prior, plus payments on those losses during the past two years minus the reserves that had been established for those losses two years earlier. The usual range for this test is less than 25 percent.

Estimated Current Reserve Deficiency to Policyholders' Surplus. This ratio provides an estimate of the adequacy of current reserves. The usual range for this test is less than 20 percent.

Unusual circumstances precluded, a company would be considered a "priority" company if it failed four or more ratios. As previously discussed, the results of the NAIC IRIS financial ratios should be reviewed and results outside the usual ranges investigated and explained.

Appendix F

Examples of Development Data

A common approach to estimating loss reserves for occurrence policies is to compile a history of the development of losses for each accident year, reviewing the historical patterns and projecting the ultimate expected losses using such patterns. Similarly, for claims-made policies, report year would be substituted for accident year. Two examples of this approach are included herein.

Although such developments are very useful in testing loss-reserve estimates, the auditor should consider the adequacy of the company's data base and the stability of loss-payment patterns. The auditor should keep in mind that there are other methods, retrospective and prospective, that may be more appropriate or that should be used in conjunction with the historical development method.

Example A. Table 1 represents a compilation of historical incurred loss-development data arrayed by accident year, by development period. Development period 12, for example, displays the amount of incurred losses (paid plus outstanding) after twelve months. For 19X0, $8,123 was incurred at the end of twelve months. Likewise, the subsequent development periods display the incurred losses for a given accident year at the various points in time; for example, the developed loss for 19X2 at the end of forty-eight months (that is, 19X5) is $9,435, and the developed loss for 19X3 at the end of thirty-six months (also 19X5) is $8,208.

Table 2 provides an estimate of the IBNR reserve by (1) computing the "period-to-period development factors" (section I); (2) computing the average factor for each development period (section II); (3) computing a period-to-ultimate factor (section III), which is the product of the successive period-to-period development factors; (4) estimating ultimate expected losses by multiplying the period-to-ultimate factor by the losses incurred to date (section IV); and estimating the IBNR reserve (section VI) as the difference between the ultimate expected losses and losses incurred to date (Table 1).

This example considers only simple averages to derive the period-to-period factors. Actual applications of this approach also should consider weighted averages and averages of the more recent history (three or four years) in determining the appropriate period-to-period factors to be used. The use of various averages will aid in determining trends and minimizing the effects of random variation.

Example B. Example B demonstrates an approach similar to Example A, except that paid loss data are used rather than incurred loss data. The computations are made in the same manner as for Example A; however, the resulting estimate is an estimate of both the case and the IBNR reserves.

Example A—Table 1 Incurred Loss Data

Accident Year	*Development Period (Months)* 12	24	36	48	60	72	84	96	108	120
19X0	8,123	8,593	8,896	8,919	8,929	8,932	8,933	8,933	8,933	8,933
19X1	8,345	8,459	8,621	8,894	8,992	8,890	8,885	8,886	8,886	
19X2	8,603	9,033	9,524	9,435	9,500	9,545	9,546	9,546		
19X3	8,002	8,621	8,208	8,288	8,419	8,365	8,363			
19X4	9,620	10,191	9,684	9,750	9,731	9,734				
19X5	7,443	8,448	8,870	8,975	8,988					
19X6	7,815	9,435	9,735	9,582						
19X7	11,089	12,319	12,174							
19X8	11,323	12,684								
19X9	12,533									

Example A—Table 2 Period-to-Period Development Factor

Accident Year	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	Estimated Tail
	(Months)									
I. 19X0	1.058*	1.035	1.003	1.001	1.000	1.000	1.000	1.000	1.000	†
19X1	1.014	1.019	1.032	1.011	0.989	0.999	1.000	1.000		
19X2	1.050	1.054	0.991	1.007	1.005	1.000	1.000			
19X3	1.077	0.952	1.010	1.016	0.994	1.000				
19X4	1.059	0.950	1.007	0.998	1.000					
19X5	1.135	1.050	1.012	1.001						
19X6	1.207	1.032	0.984							
19X7	1.111	0.988								
19X8	1.120									
II. Average	1.092	1.010	1.005	1.006	0.998	1.000	1.000	1.000	1.000	
III. Ultimate	1.113‡	1.019	1.009	1.003	0.998	1.000	1.000	1.000	1.000	1.000
	19X9	*19X8*	*19X7*	*19X6*	*19X5*	*19X4*	*19X3*	*19X2*	*19X1*	*19X0*
IV. Ultimate Losses	13,949§	12,923	12,279	9,613§	8,966	9,733	8,363	9,546	8,886	8,933
V. Last Diagonal ** (paids + case outstanding)	12,533	12,684	12,174	9,582	8,988	9,734	8,363	9,546	8,886	8,933
VI. IBNR Reserve	1,416#	239	105	31	(22)	(1)	0	0	0	

The above triangle utilizes an "incurred-to-incurred" approach in developing an estimate for IBNR reserves.

* Twenty-four-month developed losses divided by twelve-month-developed loss from Table 1 (8,593 ÷ 8,123 = 1.058).

† Applies only if development period is longer than the period covered by the model.

‡ The product of the remaining factors (1.092 × 1.010 × 1.005 × 1.006 × .988 × 1.000 = 1.113) or the product of the 12-24 average factor times the 24-36 ultimate factor (91.092 × 1.019 = 1.113).

§ The product of the developed losses times the ultimate factor (12,533 × 1.113 = 13,949; 9,582 × 1.003 = 9,613; etc.).

**Losses incurred to date from Table 1.

\# The difference between ultimate estimated losses and losses developed to date (13,949 × [sic] 12,533 = 1,416).

Example B—Table 1 Cumulative Paid Loss Data

Accident Year	Development Period (Months) 12	24	36	48	60	72	84	96	108
	($000)								
19X0	47	210	335	422	481	506	527	543	548
19X1	52	197	312	377	430	469	496	501	
19X2	52	185	273	348	407	437	479		
19X3	41	172	282	366	425	468			
19X4	41	203	319	410	479				
19X5	44	175	308	443					
19X6	44	174	282						
19X7	51	208							
19X8	68								

Example B—Table 2 Period-to-Period Development Factor

Accident Year	*(Months)* 12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	*Estimated Tail*	
19X0	4.468	1.595	1.260	1.140	1.052	1.042	1.030	1.009	*	
19X1	3.788	1.584	1.208	1.141	1.091	1.058	1.010			
19X2	3.558	1.476	1.275	1.170	1.074	1.096				
19X3	4.195	1.640	1.298	1.161	1.101					
19X4	4.951	1.571	1.285	1.168						
19X5	3.977	1.760	1.438							
19X6	3.955	1.621								
19X7	4.078									
19X8										
19X9										
Average	4.121	1.607	1.294	1.156	1.080	1.065	1.020	1.009		
Ultimate	12.895	3.129	1.948	1.505	1.302	1.206	1.133	1.110	1.100	
	19X8	*19X7*	*19X6*	*19X5*	*19X4*	*19X3*	*19X2*	*19X1*	*19X0*	*Total*
Ultimate	877	651	549	667	624	565	543	556	515	
Last Diagonal	68	208	282	443	479	468	479	501	468	
Case + IBNR Reserve	809	443	267	224	145	97	64	55	47	2,149

The above triangle utilizes a paid loss approach in developing an estimate for total loss reserves. Note that both examples are prepared on an accident-year basis. Models can also be prepared on a policy-year basis.
Computations are the same as explained in Example A.
* Applies only if development period is longer than the period covered by the model.

Appendix G

Industry and Other Organizations

The following is a list of some of the industry organizations. These sources are useful to the auditor in obtaining an understanding of the insurance industry.

American Academy of Actuaries (AAA) was founded in 1965 to represent the profession by four specialty actuarial associations: The Casualty Actuarial Society, Conference of Actuaries in Public Practice, Fraternal Actuarial Association, and Society of Actuaries. It provides standards or criteria of competence as an actuary and promotes education in actuarial science, exchange of information among actuarial organizations, and maintenance of standards of conduct and competence. The Casualty Actuarial Society provides actuarial and statistical science in insurance other than life insurance.

American Insurance Association (AIA) acts as a high-level policy organization for large stock companies. It deals with broad questions of position on proposed legislation and regulation, establishment of good public relations, and methods of conducting the business.

Alliance of American Insurers (AAI) serves mutual insurance companies in a similar capacity as the American Insurance Association.

Independent Insurance Agents of America (IIAA) promotes agent education and supports legislation of interest to the public as well as the insurance industry and opposes legislation detrimental to members' interests.

Insurance Accounting and Systems Association (IASA) develops improved theory and practice with respect to insurance accounting and systems.

Insurance Information Institute (III) serves as the vehicle for a better public understanding and acceptance of the insurance business.

Insurance Service Office (ISO) acts as the bureau developing rates and forms for many lines of insurance.

National Association of Independent Insurers (NAII) represents independent property and liability stock and mutual insurance companies by sponsoring educational programs and seminars as well as by maintaining a legislative division in Washington, D.C.

National Association of Insurance Commissioners (NAIC) is an organization of the chief insurance regulatory officials of the fifty states, the District of Columbia, and four U.S. Territories. It provides a forum for the exchange of ideas and the formulation of uniform policy. The NAIC helps commissioners fulfill their obligations of protecting the interests of insurance policyholders.

National Association of Mutual Insurance Companies (NAMIC) comprises mutual fire and casualty insurance companies. The association gathers, compiles, and analyzes information on all matters relating to insurance and to the reduction and prevention of losses. It also conducts workshops and seminars on these matters.

National Association of Professional Insurance Agents (PIA) acts in a capacity similar to that of the Independent Insurance Agents of America.

National Council on Compensation Insurance (NCII) develops and administers rating plans and systems for workers' compensation insurance.

Reinsurance Association of America (RAA) acts as spokesperson for reinsurance companies in regulatory matters and in promotion of the interests of the industry.

Society of Insurance Accountants (SIA) provides a forum for discussion and dissemination of information on accounting, statistical, and management problems in the insurance industry.

Appendix H

Statement of Position

Auditing Property and Liability Reinsurance

[The text of this Statement of Position has been deleted from this appendix and incorporated into chapter 6 of the guide.]

Appendix I

Statement of Position 90-10

Reports on Audited Financial Statements of Property and Liability Insurance Companies

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Property and Liability Insurance Companies

Issued by the Insurance Companies Committee

American Institute of Certified Public Accountants

[Superseded by the issuance of SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises,* which has been incorporated into chapter 9 of the Guide.]

Appendix J

Statement of Position 90-11

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Banks,
Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies), and
Audits of Property and Liability Insurance Companies

Issued by the
Accounting Standards Executive Committee
American Institute of
Certified Public Accountants

[Effectively superseded by the issuance of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.]

Appendix K

Statement of Position 92-3

Accounting for Foreclosed Assets

April 28, 1992

Issued by the
Accounting Standards Division
American Institute of
Certified Public Accountants

NOTICE TO READERS

Statements of Position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position as sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

TABLE OF CONTENTS

SUMMARY

This statement of position (SOP) provides guidance on measuring foreclosed assets and in-substance foreclosed assets after foreclosure. It applies to all reporting entities, except those that account for assets at fair value or market value. It applies to all assets obtained through foreclosure or repossession, except for inventories, marketable equity securities, and real estate previously owned by the lender and accounted for under FASB Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects.*

Under the SOP, there is a rebuttable presumption that foreclosed assets are held for sale. The SOP recommends that foreclosed assets held for sale be carried at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost. Foreclosed assets held for the production of income should be treated the same way they would be had the assets been acquired in a manner other than through foreclosure.

The SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992.

Accounting for Foreclosed Assets

Scope

1. This statement of position (SOP) provides guidance on determining the balance sheet treatment of foreclosed assets[1] after foreclosure. (Paragraphs A-6 and A-7 of the Appendix discuss the exclusion from this SOP of conclusions on the accounting treatment of results of operations related to foreclosed assets held for sale.) It applies to all reporting entities except those that account for assets at market value or fair value, such as broker-dealers, futures commission merchants, and investment companies. It applies to all assets obtained through foreclosure or repossession except for (*a*) inventories that are covered by chapter 4 of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*; (*b*) marketable equity securities that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (Statement) No. 12, *Accounting for Certain Marketable Securities*; and (*c*) foreclosed real estate previously owned by the lender and accounted for under FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*. Except for the requirements in paragraphs 12 and 17, the conclusions of this SOP do not apply to in-substance foreclosed assets (see paragraph A-10 of the Appendix).

Background

2. Paragraph 29 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, issued in 1977, requires the following: "After a troubled debt restructuring, a creditor shall account for assets received in satisfaction of a receivable the same as if the assets had been acquired for cash." That requirement has been interpreted in diverse ways.

3. The American Institute of Certified Public Accountants' (AICPA's) Industry Audit Guide *Audits of Stock Life Insurance Companies*[2] requires that foreclosed real estate be carried at the lower of cost (less accumulated depreciation) or market value, net of any encumbrances. Paragraphs 17 and 21 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts* (as amended by SOP 78-2), require that estimated losses on individual loans and properties be based on net realizable value. The guidance in the AICPA Audit and Accounting Guide *Audits of Savings Institutions* (May 1994) and in the Industry Audit Guide *Audits of Finance Companies* are consistent with SOPs 75-2 and 78-2. The AICPA Industry Audit Guide *Audits of Banks* (May 1994) states that subsequent to foreclosure, a loss on foreclosed real estate should be recognized if cost cannot be recovered through sale or use, but it does not indicate how the loss is to be measured. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* does not address accounting for foreclosed assets.*

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[1] As used in this SOP, the term *foreclosed assets* includes all assets received in satisfaction of a receivable in a troubled debt restructuring, as the term is used in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. It includes real property and personal property; equity interests in corporations, partnerships, and joint ventures; and beneficial interests in trusts.

[2] This guide has been superseded by the AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*.

* The AICPA Audit and Accounting Guide *Banks and Savings Institutions* superseded the Guides *Audits of Savings Institutions* and *Audits of Banks* and refers readers to FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and SOP 92-3. FASB Statement No. 121 has been superseded by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Additionally, a new combined Guide for lending and depository institutions will be available in the latter part of 2002.

4. In practice, accounting by creditors for foreclosed assets, particularly real estate assets, is diverse. After foreclosure, some enterprises continue to write down the carrying amount of foreclosed assets for subsequent, further declines in fair value; others do not. After foreclosure, some enterprises discount projected cash flows related to foreclosed assets in estimating net realizable value of those assets; others do not.

5. Sections 4(b)(1) and 4(b)(2)(A) of the Home Owners' Loan Act of 1933 as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 generally provide that the director of the Office of Thrift Supervision prescribe uniform accounting and disclosure standards for savings associations, to be used in determining associations' compliance with applicable regulations, and incorporate generally accepted accounting principles into those standards to the same degree that such principles are used to determine compliance with regulations prescribed by federal banking agencies. Section 1215 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 also provides the following:

> Before the end of the 1-year period beginning on the date of the enactment of this Act [August 9, 1989], each appropriate Federal banking agency (as defined in section 3(q) of the Federal Deposit Insurance Act) shall establish uniform accounting standards to be used for determining the capital ratios of all federally insured depository institutions and for other regulatory purposes. Each such agency shall report annually to the Chairman and ranking minority member of the Committee on Banking, Housing, and Urban Affairs of the Senate and the Chairman and ranking minority member of the Committee on Banking, Finance and Urban Affairs of the House of Representatives any differences between the capital standards used by such agency and capital standards used by any other such agency. Each such report shall contain an explanation of the reasons for any discrepancy in such capital standards, and shall be published in the Federal Register.

6. The chairman of the Federal Home Loan Bank Board (now the Office of Thrift Supervision) asked the AICPA in 1987 to address the inconsistency between banks and savings and loan associations in accounting for loans and real estate assets. The AICPA's Accounting Standards Executive Committee (AcSEC) attempted to eliminate that inconsistency in 1988 and 1989 but decided to refer the matter to the FASB at that time. On April 4, 1989, soon after AcSEC's decision to refer the matter to the FASB, the chairman of the Federal Home Loan Bank Board wrote to the chairman of the Securities and Exchange Commission (SEC) asking that the SEC or its staff remove the inconsistency for public reporting entities. The SEC has not done so.

7. Further, the chairman of the Federal Deposit Insurance Corporation, in a letter to the FASB dated November 8, 1989, asked the FASB to assist in developing "uniform accounting standards among depository institutions." In that letter, the chairman stated that "the accounting treatment in practice for certain transactions among participants in the financial services industry seems to be more a reflection of the type of charter than the substance of the transaction." Furthermore, the chairman "urge[d] the FASB to reconcile the different accounting practices outlined in [AICPA] guides for thrifts, banks, and finance companies." In early 1990, AcSEC decided that it could deal with the inconsistencies and diversity in accounting for foreclosed assets, and this SOP is a result of that decision.

8. AcSEC believes that all enterprises, not just financial institutions, should account for foreclosed assets held for sale the same way, except that

enterprises that account for assets at market value or fair value should not change their accounting. AcSEC's primary objectives in issuing this statement of position are to reduce the inconsistencies and diversity in accounting for foreclosed assets and to improve the understandability, comparability, and relevance of amounts reported as foreclosed assets in balance sheets. Another objective is to make all of the AICPA Audit and Accounting Guides and SOPs consistent on this matter. Achieving those objectives will also address the needs of Congress and the thrift and banking regulators.

9. This SOP affects the following AICPA statements of position and industry audit and accounting guides:

a. *Audits of Finance Companies*

b. *Audits of Property and Liability Insurance Companies*

c. *Audits of Stock Life Insurance Companies*

d. *Guide for the Use of Real Estate Appraisal Information*

Conclusions

Held-for-Sale Presumption

10. Most enterprises do not intend to hold foreclosed assets for the production of income but intend to sell them; in fact, some laws and regulations applicable to financial institutions require the sale of foreclosed assets. Therefore, under this SOP, it is presumed that foreclosed assets are held for sale and not for the production of income. That presumption may be rebutted, except for in-substance foreclosed assets, by a preponderance of the evidence. If the held-for-sale presumption is not rebutted, the asset should be classified in the balance sheet as held for sale.

11. The presumption of sale can be rebutted if (*a*) management intends to hold a foreclosed asset for the production of income, (*b*) that intent is not inconsistent with the enterprise's ability to do so or with laws or regulations, including the manner in which the laws or regulations are administered by federal or state regulatory agencies, and (*c*) that intent is supported by a preponderance of the evidence.

Foreclosed Assets Held for Sale

12. After foreclosure, foreclosed assets held for sale should be carried at the lower of (*a*) fair value[3] minus estimated costs to sell or (*b*) cost.[4] Such

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[3] *Fair value*, as used in this SOP, is defined in paragraph 13 of FASB Statement No. 15 as follows:

> The fair value of the assets transferred is the amount that the . . . [creditor] could reasonably expect to receive for them in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Fair value of assets shall be measured by their market value if an active market for them exists. If no active market exists for the assets transferred but exists for similar assets, the selling prices in that market may be helpful in estimating the fair value of the assets transferred. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discontinued ar a rate commensurate with the risk involved.[6]
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> ---
>
> [6] Some factors that may be relevant in estimating the fair value of various kinds of assets are described in paragraphs 88 and 89 of *APB* [Accounting Principles Board] *Opinion No. 16* ["Business Combinations"], paragraphs 12-14 of *APB Opinion No. 21*, "Interest on Receivables and Payables,"and paragraph 25 of *APB Opinion No. 29*, "Accounting for Nonmonetary Transactions."

[4] The *cost* of such assets at the time of foreclosure is the fair value of the asset foreclosed or repossessed. Any specific valuation allowance related to the loan should not be carried forward. This SOP provides no guidance for determining cost subsequent to foreclosure (see paragraphs A-6 and A-7 of the appendix).

determination should be made on an individual asset basis. If the fair value of the asset minus the estimated costs to sell the asset is less than the cost of the asset, the deficiency should be recognized as a valuation allowance. If the fair value of the asset minus the estimated costs to sell the asset subsequently increases and the fair value of the asset minus the estimated costs to sell the asset is more than its carrying amount, the valuation allowance should be reduced, but not below zero. Increases or decreases in the valuation allowance should be charged or credited to income.[5]

13. The amount of any senior debt (principal and accrued interest) to which the asset is subject should be reported as a liability at the time of foreclosure and not be deducted from the carrying amount of the asset; payments on such debt should be charged to the liability. Interest that accrues after foreclosure should be recognized as interest expense.

14. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, was extracted by the FASB from SOP 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of Real Estate Projects*; SOP 80-3, *Accounting for Real Estate Acquisition, Development, and Construction Costs*, and the AICPA Industry Audit Guide *Accounting for Retail Land Sales*. These documents did not, in the opinion of AcSEC, apply to foreclosed real estate held for sale. AcSEC therefore believes that the fair-value test in this SOP, not the net-realizable-value test in FASB Statement No. 67, should be applied to foreclosed real estate held for sale, except when the foreclosed real estate was previously owned by the lender and accounted for under FASB Statement No. 67, in which case such foreclosed assets should be accounted for under FASB Statement No. 67.

Foreclosed Assets Held for the Production of Income

15. After foreclosure, assets determined to be held for the production of income (and not held for sale) should be reported and accounted for in the same way that they would be had the assets been acquired other than through foreclosure.

Change in Classification

16. If it is subsequently decided that a foreclosed asset classified as held for sale will be held for the production of income, the asset should be reclassified from the held-for-sale category. The reclassification should be made at the amount the asset's carrying amount would have been had the asset been held for the production of income since the time of foreclosure. Selling costs included in the valuation allowance should be reversed. The net effect should be reported in income from continuing operations in the period in which the decision not to sell the asset is made.

Effective Date and Transition

17. This SOP should be applied to foreclosed assets in annual financial statements for periods ending on or after December 15, 1992, with earlier application permitted. On initial application of this SOP, all enterprises should adjust the carrying amount of foreclosed assets held for sale to the lower of (*a*) the fair value of the asset minus the estimated costs to sell the asset or (*b*) the cost of the asset as of the date of the initial adoption of this SOP. For many

[5] Because the allowance is considered a valuation adjustment, insurance enterprises should report changes in the valuation allowance as realized gains and losses in income, not as unrealized gains and losses in equity.

enterprises, adoption of this SOP will result in a change in accounting principle. The nature of the change should be disclosed in the financial statements of the period in which the change is made. Any adjustment arising from the initial application of this SOP should be included in income from continuing operations in the period in which the change is made. No restatement of previously issued financial statements or cumulative-effect adjustment as of the beginning of the year this SOP is first applied is permitted.

APPENDIX

Discussion of Major Comments on the Exposure Draft

A-1. This Appendix summarizes considerations that were deemed significant by members of AcSEC in reaching the conclusions in this SOP.

A-2. In the exposure draft, AcSEC concluded that there is a rebuttable presumption that foreclosed assets are held for sale and that foreclosed assets held for sale should be carried at the lower of cost or fair value minus the estimated costs to sell. Few respondents objected to those conclusions.

Held-for-Sale Presumption

A-3. Some respondents requested more explanation of the circumstances under which the held-for-sale presumption could be rebutted. After considering the concerns expressed by respondents about the rebuttable presumption, AcSEC decided not to give detailed, specific guidance, thereby allowing for the exercise of judgment in determining whether the presumption is rebutted by the facts in particular circumstances.

A-4. AcSEC recognizes that some enterprises may hold foreclosed assets for several years before sale and may even operate the assets, but concludes that a holding period in excess of one year does not, in and of itself, rebut the held-for-sale presumption. Further, AcSEC notes that if the form of the foreclosed asset is a majority interest in an enterprise, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, requires the subsidiary to be consolidated unless control is likely to be temporary.

Fair Value

A-5. Some respondents requested guidance on the determination of fair value. AcSEC recognizes that estimating fair value requires judgment. AcSEC concluded, however, that it would be inappropriate and is unnecessary to develop a new definition of fair value in this SOP, and that the definition of fair value in FASB Statement No. 15 should be used in this SOP. Moreover, AcSEC believes that the following discussion about fair value from Statement No. 15, particularly paragraph 82, will be helpful in implementing this SOP.

Concept of Fair Value

79. Some respondents to the Exposure Draft continued to argue that all troubled debt restructurings should be accounted for as modifications of the terms of debt and that none should be accounted for as transfers of assets (paragraphs 66 and 67). Others accepted the need to account for some troubled debt restructurings as asset transfers but held that obtaining assets through foreclosure or repossession under terms included in lending agreements should be distinguished from obtaining assets in exchange for cash or in other "asset swaps." They contended that (*a*) only the form of the asset is changed by foreclosure or repossession, (*b*) the substance of a secured loan is that the lender may choose either to postpone receipt of cash or take the asset to optimize cash receipts and recovery of its investment, and (*c*) foreclosure or repossession is not the completion of a lending transaction but merely a step in the transaction that begins with lending cash and ends with collecting cash.

80. The Board rejected those arguments for the reasons given in paragraphs 71-77, emphasizing that an event in which (*a*) an asset is transferred between debtor and creditor, (*b*) the creditor relinquishes all or part of its claim against the debtor, and (*c*) the debtor is absolved of all or part of its obligation to the creditor is the kind of event that is the basis of accounting under the existing transaction-based accounting framework. To fail to recognize an event that fits the usual description of a transaction and to recognize only the lending and collection of cash as transactions would significantly change the existing accounting framework.

81. Use of the fair value of an asset transferred to measure the debtor's gain on restructuring and gain or loss on the asset's disposal or the creditor's cost of acquisition is not adopting some kind of "current value accounting." On the contrary, that use of fair value is common practice within the existing accounting framework. Paragraph 13 of this Statement explains briefly the meaning of *fair value* and refers to *APB Opinions No. 16, No. 21*, and *No. 29*, which use *fair value* in the same way and provide guidance about determining fair values within the existing accounting framework. The term *fair value* is used in essentially the same way as *market value* was used in the Discussion Memorandum to denote a possible attribute to be measured at the time a debt is restructured. *Fair value* is defined in paragraph 181 of *APB Statement No. 4* as "the approximation of exchange price in transfers in which money or money claims are not involved." Although a "money claim" is necessarily involved in transferring assets to settle a payable in a troubled debt restructuring, the troubled circumstances in which the transfer occurs make it obvious that the amount of the "money claim" does not establish an exchange price. Determining fair value of the assets transferred in a troubled debt restructuring is usually necessary to approximate an exchange price for the same reasons that determining fair value is necessary to account for transfers of assets in nonmonetary transactions (*APB Opinion No. 29*).

82. That point is emphasized in this Appendix because some respondents to the Exposure Draft apparently misunderstood the concept of fair value (paragraph 11 of the Exposure Draft and paragraph 13 of this Statement) and the discounting of expected cash flows specified in those paragraphs. *Paragraph 13 permits discounting of expected cash flows from an asset transferred or received in a troubled debt restructuring to be used to estimate fair value only if no market prices are available either for the asset or for similar assets. The sole purpose of discounting cash flows in that paragraph is to estimate a current market price as if the asset were being sold by the debtor to the creditor for cash. That estimated market price provides the equivalent of a sale price on which the debtor can base measurement of a gain on restructuring and a gain or loss on disposal of the asset and the equivalent of a purchase price on which the creditor can measure the acquisition cost of the asset. To approximate a market price,*

the estimate of fair value should use cash flows and discounting in the same way the marketplace does to set prices—in essence, the marketplace discounts expected future cash flows from a particular asset "at a rate commensurate with the risk involved" in holding the asset. An individual assessment of expected cash flows and risk may differ from what the marketplace's assessment would be, but the procedure is the same. [Emphasis added by AcSEC.]

83. In contrast to the purpose of paragraph 13, *AICPA Statement of Position No. 75-2,*[31] is concerned with different measures—net realizable value to a creditor of a receivable secured by real property and net realizable value of repossessed or foreclosed property. Its method of accounting for assets obtained by foreclosure or repossession thus differs from the method specified in this Statement. It proposes discounting expected cash flows at a rate based on the creditor's "cost of money" to measure the "holding cost" of the asset until its realizable value is collected in cash. The concept of fair value in paragraph 13 does not involve questions of whether interest is a "holding cost" or "period cost" because it is concerned with estimating market price, not net realizable value, however defined. Accounting for transfers of assets in troubled debt restructurings and for the assets after transfer is, of course, governed by this Statement.*

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[31] See paragraphs 59 and 60 of this Statement.

* *Note:* Paragraph 13 of SOP 75-2, *Accounting Practices of Real Estate Investment Trusts*, has been effectively superseded by FASB Statement No. 114, *Accounting by Creditors for the Impairment of a Loan*, and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Results of Operations Related to Foreclosed Assets Held for Sale

A-6. In the exposure draft, AcSEC proposed that there should be no results of operations—revenues and expenses—from foreclosed assets while they are held for sale; net cash receipts related to foreclosed assets during the holding period would have been credited to the carrying amount of the asset, and net cash payments, except for capital additions and improvements, would have been charged to income as a loss on holding the foreclosed assets. Further, in the exposure draft, AcSEC concluded that no depreciation, depletion, or amortization expense should be recorded. Many respondents objected to the exclusion of the results of operating a foreclosed asset from income; many also objected to crediting net cash receipts to the carrying amount of the asset and charging net cash payments to income. They raised questions about the conservatism of such treatment, about whether the treatment was conceptually sound, and about whether it would be practical to implement. Some comment letters also raised questions about whether it is appropriate not to depreciate foreclosed assets held for sale. After considering the comments, AcSEC decided not to adopt the method proposed in the exposure draft.

A-7. AcSEC considered various other ways to account for operations during the period foreclosed assets are held for sale, such as—

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets, for each reporting period as a gain or loss on holding the asset.
- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance and depreciation expense on depreciable assets held or expected to be held for more than a specified length of time (for example, one year).

- Reporting the net of revenues and expenses in income, including charges or credits related to changes in the valuation allowance, and recognizing no depreciation expense.
- Crediting or debiting the net of revenues and expenses to the asset, and recognizing no depreciation expense. Changes in the valuation allowance would be included in income.

AcSEC believes that it should consider those options further and that its ultimate decision on the treatment of operations during the period foreclosed assets are held for sale should be exposed for public comment; AcSEC intends to undertake such a project. However, because AcSEC believes that its conclusion that foreclosed assets held for sale should be carried at the lower of fair value minus estimated costs to sell or cost would not change regardless of its conclusions on operations of foreclosed assets, AcSEC decided that it should issue the guidance in this SOP now, rather than delay issuing the guidance until the results of operations issues are resolved.

Foreclosed Assets Held for the Production of Income

A-8. In the exposure draft, AcSEC proposed to require that foreclosed assets held for the production of income be carried at an amount not greater than the assets' net realizable value. AcSEC decided to eliminate that statement.

Change in Classification

A-9. AcSEC also decided that, on reclassification of a foreclosed asset from the held-for-sale category, the asset should be measured and recorded as if the asset had been held for the production of income since foreclosure. That decision is consistent with the consensus of the Emerging Issues Task Force in Issue 2 of Issue 90-6, where the reversal of a decision to sell an asset acquired in a business combination gives rise to an accounting as if the asset had never been held for sale.

In-Substance Foreclosed Assets

A-10. Many respondents asked for specific guidance on in-substance foreclosed assets, and they asked whether the SOP would apply to such assets. AcSEC concluded that, except for paragraphs 12 and 17, the guidance in this SOP need not be applied to in-substance foreclosures for the following reasons:

a. The accounting for in-substance foreclosed assets was not explicitly addressed in the exposure draft.

b. AcSEC would have found it difficult to resolve issues concerning senior debt related to in-substance foreclosed assets.

However, AcSEC notes that paragraph 34 of FASB Statement No. 15; paragraph 6 of AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed;** and SEC Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* include accounting guidance related to in-substance foreclosed assets indicating that in-substance foreclosed assets should be accounted for in the same way as assets that have actually been foreclosed or repossessed. Further, AcSEC concluded that for purposes of applying this SOP, the held-for-

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* Practice Bulletin 7 was withdrawn in December 1994 by the Accounting Standards Executive Committee.

sale presumption could not be rebutted for in-substance foreclosed assets. Accordingly, after in-substance foreclosure, an in-substance foreclosed asset, like a foreclosed asset held for sale, would be reported in the balance sheet at the lower of (*a*) fair value minus estimated costs to sell or (*b*) cost.

Carrying Amount of Assets at Foreclosure

A-11. Some respondents expressed concerns and opinions about the carrying amount of the foreclosed assets to be recognized at foreclosure. The exposure draft indicated that the attribute to be recognized at foreclosure should be the fair value of the collateral, implying that, if at the time of foreclosure the fair value of the collateral is greater than the recorded investment in the related loan, a credit to income would result. Some respondents suggested that no such credits should be permitted and that the carrying amount of the asset recognized at foreclosure should be the lower of the fair value of the collateral or the recorded investment in the loan. Notwithstanding those concerns, AcSEC notes that paragraph 28 of FASB Statement No. 15 requires that foreclosed assets be accounted for at their fair value at the time of foreclosure.

A-12. Some respondents also said that the definition of *fair value*, which is the definition in paragraph 13 of FASB Statement No. 15, implicitly contains a reduction for selling costs. For purposes of applying this SOP, AcSEC believes that the definition of fair value in paragraph 13 of FASB Statement No. 15 should be viewed as the cash sales/purchase price in a principal-to-principal transaction wherein no agents, dealers, brokers, or commission merchants are involved. If either principal decides to involve and pay outsiders to assist that principal, or to bring principals together, any amount paid by that principal is independent of the fair value of the asset and does not affect that fair value. Accordingly, immediately after foreclosure, a valuation allowance related to foreclosed assets held for sale should be recognized for estimated costs to sell through a charge to income.

Offsetting of Debt

A-13. Contrary to what was proposed by AcSEC in the exposure draft, some respondents suggested that nonrecourse senior debt not assumed by the holder of the foreclosed asset be offset against the carrying amount of the asset. To protect its interest in the asset, the holder of the asset will have to settle the debt or have a subsequent transferee take the asset subject to the debt. If debt is offset, leverage is not portrayed, and the degree of possible gain is obscured. Moreover, offsetting nonrecourse senior debt against a foreclosed asset would be inconsistent with the manner in which such debt is portrayed when assets are purchased for cash and there is related nonrecourse debt. Therefore, AcSEC reaffirms that senior debt should not be offset against the asset.

Transition

A-14. Comments were specifically requested on the transition proposed in the exposure draft. Most respondents agreed that determining the cumulative effect of the change in accounting principle would either be impossible or possible only at significant cost for enterprises that do not have available the fair value of foreclosed assets at earlier balance sheet dates, and that a restatement of previously issued financial statements or a cumulative effect adjustment should not be required. Further, AcSEC concluded that, because one of the principal objectives of this SOP is to have consistent accounting of foreclosed assets, those two alternatives should not be permitted.

Appendix L

Statement of Position 92-4

Auditing Insurance Entities' Loss Reserves

May 29, 1992

Supplement to
AICPA Audit and Accounting Guide
Audits of Property and Liability Insurance Companies

Prepared by the Auditing Insurance Entities' Loss Reserves Task Force of the Insurance Companies Committee
Accounting Standards Division
American Institute of Certified Public Accountants

[The text of this Statement of Position has been deleted from this appendix and incorporated into chapter 4 and appendix A of the guide.]

Appendix M

Statement of Position 92-5

Accounting for Foreign Property and Liability Reinsurance

June 1, 1992

Supplement to
AICPA Audit and Accounting Guide
Audits of Property and Liability Insurance Companies

Prepared by the AICPA Reinsurance Auditing and Accounting Task Force of the Insurance Companies Committee

American Institute of Certified Public Accountants

[The text of this Statement of Position has been deleted from this appendix and incorporated into chapter 6 of the guide.]

Appendix N

Statement of Position 92-8

Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

October 26, 1992

Prepared by the Insurance Companies Committee
Accounting Standards Division
American Institute of
Certified Public Accountants

NOTICE TO READERS

This statement of position presents the recommendations of the Insurance Companies Committee regarding the audit of property/casualty insurance entities' statutory financial statements in applying certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions. It has been reviewed by the chairman of the Auditing Standards Board for consistency with auditing standards. AICPA members may have to justify departures from the recommendations in this statement of position if their work is challenged.

Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

Applicability

1. This statement of position (SOP) provides guidance on the impact of certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property/casualty insurance entities.

Introduction

2. The NAIC's Annual Statement Instructions direct property/casualty insurers to require their independent certified public accountants to subject the current Schedule P—Part 1 (excluding those amounts related to bulk and incurred-but-not-reported [IBNR] reserves and claim counts) to the auditing procedures applied in the audit of the current statutory financial statements to determine whether Schedule P—Part 1 is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole. Schedule P—Part 1 includes Part 1—Summary and Part 1A—1R.

3. Although no separate report on Schedule P—Part 1 is required by the NAIC, the auditor should consider the provisions of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and the provisions of this SOP. However, the requirements of this SOP do not preclude an auditor from issuing a report similar to that illustrated in paragraph 12 of SAS No. 29.

Auditing Procedures

4. Certain of the information in Schedule P—Part 1 is typically subjected to auditing procedures applied in the audit of the basic statutory financial statements (for example, premiums earned and losses paid). Other information not directly related to the basic statutory financial statements is also presented (for example, lines of business classifications for immaterial lines). Although such information may not have been subjected to auditing procedures applied in the audit of the basic statutory financial statements in all instances, such information may have been derived from accounting records that have been tested by the auditor.

5. Paragraph 7 of SAS No. 29 states that although an auditor is not required by generally accepted auditing standards to apply auditing procedures to information presented outside of the basic financial statements, he or she may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements.

6. In applying auditing procedures to the information presented in Schedule P—Part 1, the guidance about auditing the claims data base in paragraphs

4.1 and 4.2 of AICPA's SOP 92-4, *Auditing Insurance Entities' Loss Reserves*, applies. The auditor should also refer to chapter 4 and exhibit B-2 in appendix B of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*.

7. As stated in paragraph 4.2 of SOP 92—4, because claim data and characteristics such as dates and types of loss can significantly influence reserve estimation, the auditor should test the completeness, reliability, and classification of the claim loss and loss expense data during the audit of the statutory financial statements. In extending those procedures to Schedule P—Part 1, the auditor should determine that—

a. The data presented on Schedule P—Part 1 is properly reconciled to the statistical records of the company.

b. Changes between the prior-year and current-year Schedule P—Part 1 are properly reconciled to the current-year audited statutory financial statements.

c. The source of the data for the auditing procedures applied to the claim loss and loss adjustment expense data during the current calendar year (for example, tests of payments on claims for all accident years that were paid during the current calendar year) is the same as (or reconciles to) the statistical records that support the data presented on Schedule P—Part 1.

8. If, as a result of the procedures performed during the audit of the statutory financial statements, the auditor becomes aware that Schedule P—Part 1 is not fairly stated in relation to the financial statements taken as a whole, the auditor should communicate to the company's management and the opining actuary that Schedule P—Part 1 is not fairly stated and should describe the misstatement. If the company will not agree to revise Schedule P—Part 1, the auditor should issue a report on Schedule P—Part 1 and should include a description of the misstatement in that report. (The auditor should refer to SAS No. 29 when a report will be issued.) The auditor should consider the impact of a misstatement in Schedule P—Part 1 on the auditor's report on the statutory financial statements.

Effective Date

9. This SOP is effective for audits of statutory-basis financial statements of property/casualty insurance entities for periods ending after December 15, 1992.

Appendix O

Statement of Position 94-1

Inquiries of State Insurance Regulators

April 20, 1994

Amendment to
AICPA Audit and Accounting Guide
Audits of Property and Liability Insurance Companies
and AICPA Industry Audit Guide
Audits of Stock Life Insurance Companies*

Prepared by the
Insurance Companies Committee
Accounting Standards Division

[The text of this Statement of Position has been incorporated into chapter 2 of the guide.]

* This guide has been superseded by the AICPA Audit and Accounting Guide, *Life and Health Insurance Entities.*

Appendix P

Statement of Position 94-5

Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises

December 15, 1994

Prepared by the Task Force on Insurance Companies' Disclosures Accounting Standards Division

[The following represents information contained in appendix B of SOP 94-5.* Paragraphs 1 through 12 and appendix A of the SOP have been incorporated into chapter 4 of this Guide.]

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* A proposed SOP, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification* amends SOP 94-5. This proposed SOP is expected to be issued as a final SOP during the summer of 2001. Practitioners should be alert to the issuance of a final SOP and ensure that they follow the guidance and reporting requirements contained therein. Appendix B of SOP 94-5, contained in this Appendix, does not reflect the changes proposed by the forthcoming SOP.

APPENDIX B

Discussion of Conclusions

B-1. This section discusses factors that were deemed significant by members of AcSEC in reaching the conclusions in this SOP. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

B-2. The business and regulatory environment of insurance enterprises has become more complex and volatile, and therefore riskier. Accordingly, AcSEC believed the need existed to reconsider the disclosures made in the financial statements of insurance enterprises.

B-3. FASB Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, states financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources...and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40).

B-4. AcSEC considered a wide variety of potential disclosures, and tried to identify the areas of importance to insurance enterprises for which the current disclosures were lacking. AcSEC concluded that additional disclosures in the financial statements of insurance enterprises about regulatory risk-based capital, the liability for unpaid claims, and certain accounting methods permitted by state insurance departments would help insurance enterprises better meet the objectives of financial reporting in their financial statements.

Risk-Based Capital

B-5. Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state insurance departments for ensuring that their objectives are being met is risk-based capital (RBC).

B-6. The NAIC has developed an RBC program that is used by state insurance departments to enable them to take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating financial conditions. This program is encompassed in the RBC Model Acts for life and property and casualty insurers, which have been or are intended to be adopted by most of the states. RBC is a series of dynamic surplus-related formulas set forth in the NAIC's RBC instructions for life and health and for property and casualty insurance enterprises. The formulas contain a variety of weighing factors that are applied to financial balances or to levels of activity based on the perceived degree of certain risks, such as asset risk, credit risk, interest rate risk (life insurance enterprises only), underwriting risk, and other business risks, such as risks related to management, regulatory action, and contingencies. The amount determined under such formulas, the authorized control level risk-based capital, is required to be disclosed in life insurance enterprises' statutory filings starting for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings starting for the year ended December 31, 1994.

B-7. The exposure draft of the SOP contained a requirement that insurance enterprises that are required to calculate RBC should disclose in their financial statements the ratio of total adjusted capital to authorized control level RBC and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented.

B-8. However, the NAIC's RBC Model Acts for both life and property and casualty insurers have a confidentiality provision, which states:

> [E]xcept as otherwise required under the provisions of this Act [that is, in the annual financial reports filed with state insurance departments], the making, publishing, disseminating, circulation, or placing before the public, or causing, directly or indirectly to be made, placed before the public, in a newspaper, magazine or other publication...with regard to the RBC levels of any insurer...would be misleading and is therefore prohibited.

B-9. Prior to issuing the exposure draft, based on discussions with the drafters of the RBC Model Acts and some state insurance regulators, and based on the fact that the information is already in the public domain, AcSEC believed that the confidentiality provisions were not intended to apply to disclosures in financial statements. However, a number of respondents to the exposure draft stated that they believe disclosing RBC levels in financial statements would be illegal in states that have enacted the RBC Model Acts. They point out that words in the RBC Model Acts appear to be intended to restrict *all* other disclosure of RBC levels, including in insurers' financial statements.

B-10. AcSEC continues to believe, because of the importance of RBC in the regulatory oversight of insurance enterprises, that its disclosure would improve the relevance and usefulness of insurance enterprises' financial statements, and, therefore, it should be disclosed in the financial statements. Nevertheless, AcSEC concluded the legal issues require further consideration.

B-11. AcSEC decided that this SOP should not be delayed while the legal issues regarding RBC disclosures are considered. A separate SOP on RBC disclosures will be considered at a later date.

B-12. Nevertheless, AcSEC encourages insurance enterprises to disclose RBC levels if they are domiciled in states that have not adopted the RBC Model Acts, or if they have otherwise determined that it is legal to make such disclosures in their financial statements.

B-13. The exposure draft also required insurance enterprises whose level of RBC has triggered a regulatory event[1] to disclose certain information in their financial statements. Delaying the issuance of the RBC guidance does not change the fact that under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, auditors must consider the

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[1] Under the NAIC's RBC Model Acts, when the ratio of total adjusted capital to authorized control level RBC is less than or equal to 2 or less than or equal to 2.5 with negative trends for life insurance enterprises, a regulatory event exists—that is, the insurance enterprises would fail to meet the minimum RBC requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event.

need for disclosures about the principal conditions and events that triggered the regulatory event and the possible effects of such conditions and events, as well as management's plans.

Permitted Statutory Accounting Practices

B-14. Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements, except to the extent that they have been disclosed in the accounting practices and procedures note to the statutory financial statements. With increasing frequency, insurance enterprises have transactions that are not explicitly addressed by prescribed accounting practices, or for which no analogous prescribed accounting practices exist. Furthermore, insurance enterprises often request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state, and from company to company within a state, and may change in the future. Moreover, permitted statutory accounting practices have been used to enhance insurance enterprises' surplus positions. For example, some state insurance departments have permitted certain insurance enterprises to adjust home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical cost.

B-15. AcSEC believes the required disclosure of permitted statutory accounting practices will enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, policyholders, and other users of an insurance enterprise's financial statements with useful information. Not only will such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and RBC position, but they also will improve the comparability of insurance enterprises' financial statements.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-16. Insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60. The liability is estimated based on past loss experience, adjusted for current trends and other factors that will modify past experience. The liability may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

B-17. FASB Concepts Statement No. 1, paragraph 21, states:

> The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical....Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability....To provide information about the past as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

B-18. AcSEC believes that disclosures about an insurance enterprise's liabilities for unpaid claims and claim adjustment expenses development are useful in understanding insurance enterprises' liabilities and results of operations. Furthermore, AcSEC notes the disclosures are the same as some of the loss reserve development disclosures that the SEC requires registrants to file with the commission under Securities Act Guide 6.

B-19. Paragraph 60(a) of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued, for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to difficult-to-estimate liabilities (such as those related to environmental related illness claims and toxic-waste cleanup claims), traditional loss reserving techniques may not be used in estimating such liabilities. Therefore, a high degree of judgment is needed in estimating the amount of losses, and practice is developing in the area. Accordingly, AcSEC believes financial statement users will benefit from disclosure of the policies and methods management has used for estimating these amounts.

Discussion of Comments Received on Exposure Draft

B-20. An exposure draft of a statement of position, *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises* was issued on April 20, 1994, and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Forty comment letters were received on the exposure draft.

Risk-Based Capital

B-21. A number of comments were received on the risk-based capital disclosures. As discussed in paragraphs B-5 through B-13, AcSEC decided to consider a separate SOP at a later date on risk-based capital disclosures. The comments will be addressed at that time.

Permitted Statutory Accounting Practices

B-22. A number of respondents to the exposure draft of the SOP requested that the disclosure requirements for permitted statutory accounting practices be postponed until after the codification is complete. AcSEC believes that the disclosures are especially important before codification to improve understanding of the factors that affect comparability among the statutory capital of insurance enterprises.

B-23. Respondents asked for clarification of how disclosure of the monetary effect of statutory surplus would be calculated, particularly when there is no prescribed accounting practice to compare with the permitted practice. AcSEC agreed and revised the exposure draft to state that for permitted statutory accounting practices used when prescribed accounting practice is silent, a description of the transaction is sufficient. Respondents also asked for clarification about whether there should be disclosure of GAAP-permitted practices when there is no prescribed statutory accounting. If an insurance company uses a GAAP practice in its statutory financial statements when there is no prescribed practice, that is still considered a permitted statutory accounting practice. However, AcSEC agreed that no disclosures should be made for GAAP practices that are used when prescribed statutory practices do not specify the accounting for the transaction.

B-24. Respondents suggested that the requirement in the exposure draft to make a statement about the codification be eliminated. AcSEC agreed the disclosure might be confusing to users of financial statements, and eliminated the requirement.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-25. The exposure draft would have required disclosure of information about actuarial adjustments made for nonrecurring or abnormal experience. A number of respondents suggested that that disclosure requirement be eliminated. AcSEC was persuaded that such actuarial adjustments are a normal part of making estimates that should not be disclosed in the financial statements, and eliminated the requirement.

Appendix Q

Practice Bulletin 15

January 1997

Accounting by the Issuer of Surplus Notes

Prepared by the
AICPA Insurance Companies Committee

NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA practice bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this practice bulletin should be used, or the member should be prepared to justify the departure.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in Practice Bulletins issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document and (2) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project and issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

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Accounting by the Issuer of Surplus Notes

Introduction and Background

1. Surplus notes[1] are financial instruments issued by insurance enterprises that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

2. The following are some general characteristics of surplus notes:

- Approval of the issuance by the domiciliary state insurance commissioner (commissioner)
- Stated maturity date in most but not all cases
- Scheduled interest payments
- Approval of the payment of principal and interest by the commissioner
- Nonvoting
- Subordinate to all claims except those of shareholders for stock companies
- Subordinate to all claims except policyholder residuals for mutual companies (after policyholder liabilities are settled)
- No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency
- Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a readily determinable fair value satisfactory to the commissioner

3. Mutual insurance enterprises are owned by their policyholders and cannot raise capital by issuing shares of common or preferred stock; thus, many mutual insurance enterprises have issued surplus notes. Early issuances of surplus notes were generally by financially troubled mutual insurance enterprises in need of raising capital with limited alternatives to do so. More recently, mutual life insurance enterprises which do not have access to traditional equity capital markets, have viewed these instruments as a viable method of raising capital and improving risk-based capital ratios.

4. Mutual life insurance enterprises currently account for surplus notes under statutory accounting practices almost universally as equity capital or surplus. Surplus treatment is allowed for statutory accounting purposes because of the regulatory control over an insurance enterprise's ability to repay interest and principal that is maintained through required approval of payment by the commissioner.

5. The accounting for and presentation of surplus notes under generally accepted accounting principles (GAAP) is a significant issue to mutual life insurance enterprises when implementing FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises,* and FASB Statement of Financial Accounting Standards

[1] The term surplus notes is the most common term applied to these financial instruments. Some jurisdictions refer to these financial instruments as certificates of contribution, surplus debentures, or capital notes.

No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts.* According to FASB Interpretation No. 40 as amended by FASB Statement No. 120, mutual life insurance enterprises that issue financial statements for fiscal years beginning after December 15, 1995, that are described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. Current authoritative accounting pronouncements are silent as to the accounting for surplus notes. Due to the prevalence and increasing use of these instruments by all kinds of insurance enterprises in the marketplace, GAAP guidance is necessary.

Scope

6. This Practice Bulletin applies to life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies that issue surplus notes. It provides guidance on accounting, financial statement presentation, and disclosure by the issuers of surplus notes in their GAAP financial statements. This Practice Bulletin does not apply to investors in surplus notes.

Conclusions

Balance-Sheet Classification of Outstanding Surplus Notes

7. Surplus notes should be accounted for as debt instruments and presented as liabilities in the financial statements of the issuer. Equity treatment for surplus notes is inappropriate. This Practice Bulletin does not establish new guidance for accounting for debt instruments by the issuer.

8. Consistent with paragraph 16 of FASB Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, a debtor shall derecognize a surplus note if and only if it has been extinguished. According to paragraph 16 of FASB Statement No. 125,[2] a liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. [*Footnote omitted*]

Accrual of Interest

9. Interest should be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner, and recognized as an expense in the same manner as other debt.

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[2] FASB Statement No. 140 supersedes FASB Statement No. 76, *Extinguishment of Debt.*

Disclosure

10. Issuers of surplus notes should comply with existing disclosure requirements for debt instruments. In addition, disclosure is required regarding the commissioner's role and ability to approve or disapprove any interest and principal payments.

Effective Date and Transition

11. This Practice Bulletin is effective for financial statements for fiscal years beginning after December 15, 1995. The effect of initially applying this Practice Bulletin shall be reported retroactively through restatement of all previously issued financial statements presented for comparative purposes. The cumulative effect of adopting this Practice Bulletin, including the accrual if interest, if any, shall be included in the earliest year restated.

The provisions of this Practice Bulletin need not be applied to immaterial items.

Basis for Conclusions

12. This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this Practice Bulletin. It includes reasons for accepting certain views and rejecting others.

Balance-Sheet Classification of Outstanding Surplus Notes

13. AcSEC considered the characteristics of surplus notes and deemed them liabilities in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements.*

14. FASB Concepts Statement No. 6 defines both liabilities and equity and describes their essential characteristics. Paragraph 35 of the Concepts Statement defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."

15. Paragraph 36 of FASB Concepts Statement No. 6 describes the following three essential characteristics of a liability.

> (*a*) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (*b*) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (*c*) the transaction or other event obligating the entity has already happened.

16. Surplus notes represent a present duty to the holders of the notes that entails settlement by probable future transfers of cash. The future transfers of cash are normally on specified dates, subject to the approval of the commissioner. If the commissioner does not grant approval for payment on a specified date, the future transfer of cash takes place on occurrence of a specified event, which is the ultimate approval of the commissioner. Therefore, surplus notes meet the first characteristic of a liability. In addition, AcSEC observed that declaration of bankruptcy by an enterprise and the role of the court in determining when and in what amounts an obligation will be settled do not affect whether the debt instrument continues to qualify as a liability.

17. Should the commissioner not grant approval for an interest or principal payment, the issuer cannot make the payment and the holders of the notes have no recourse. The commissioner will grant approval only if it is consistent with his or her responsibility and objective to maintain the solvency and financial stability of the insurer. Although the commissioner has discretion, AcSEC concluded that the commissioner is not part of the organization. The discretion described in FASB Concepts Statement No. 6 is not delegable outside the enterprise. The entity has little or no discretion to avoid the future sacrifice and thus surplus notes do meet the second characteristic of a liability.

18. AcSEC concluded that the previous transfer of cash to enterprises from the noteholder in return for the issuance of the surplus note is the event needed to obligate the entity and therefore surplus notes meet the third characteristic of a liability.

19. Equity of a business enterprise is defined in paragraph 60 of FASB Concepts Statement No. 6 simply as a residual interest—the difference between an enterprise's assets and its liabilities. Equity of a business enterprise stems from ownership rights or the equivalent, and it involves a relationship between an enterprise and its owners rather than as employees, suppliers, lenders, or in other nonowner roles.

20. FASB Concepts Statement No. 6 explains that the essential characteristics of equity center on the conditions for transferring enterprise assets to the holders of equity interests. Distributions to owners are at the discretion and volition of the owners or their representatives after satisfying restrictions imposed by law, regulation, or agreements with other entities. In most circumstances, an enterprise is not obligated to transfer assets to owners except in the event of the enterprise's liquidation unless it formally acts to do so, such as by declaring a dividend. An enterprise's liabilities and equity are mutually exclusive claims to or interests in its assets by other entities, and liabilities take precedence over ownership interests.

21. Surplus note payments require the approval of the commissioner. The commissioner's responsibilities and objectives include maintaining the solvency and financial stability of the insurer. AcSEC concluded that although the commissioner has the ability to restrict payments of interest and principal, the issuer continues to have the obligation even though the timing may be uncertain. Actions by the commissioner do not formally discharge the issuer's obligations to pay the principal or interest. Therefore, the characteristics of surplus notes are not consistent with the characteristics of equity as described in FASB Concepts Statement No. 6.

Surplus Notes—Statutory Basis

22. Statutory accounting practices for surplus notes generally are consistent among all the states. Once approved by the commissioner, these instruments are classified as surplus on the balance sheet. Interest is reported as an expense and a liability only after payment has been approved by the commissioner. Interest that has not yet been approved for payment is not accrued as an expense and liability but rather disclosed in the notes to the financial statements. AcSEC observed that the objectives of regulatory accounting requirements are not always consistent with GAAP, and differences in accounting for other transactions currently exist.

Other Instruments With Similar Characteristics

23. AcSEC considered other instruments with similar characteristics to surplus notes. Subordinated liabilities of broker/dealers, mandatorily redeemable preferred stock, and hybrid preferred securities such as monthly/quarterly income preferred stock (MIPS/QUIPS) have characteristics of both liabilities and equity and are generally presented on the balance sheet as a separate component between liabilities and equity.

Subordinated Liabilities of Broker/Dealers

24. Insurance enterprise surplus notes have many of the same characteristics as subordinated liabilities of brokers and dealers in securities. Both kinds of instruments qualify as capital for regulatory purposes, are subordinated to all other claims except those of owners, and require regulatory approval or meeting of prescribed regulatory conditions before repayment. The revised AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* does not permit reporting combined subordinated liabilities with stockholders' equity in the statement of financial condition, which was acceptable under the superseded guide. The superseded presentation was believed to be misleading because it implied that subordinated liabilities are a component of stockholders' equity, unencumbered by the right of the creditor to be repaid. Liabilities frequently have repayment limitations of one sort or another, but nevertheless remain liabilities. AcSEC concluded that accounting for surplus notes as a liability is consistent with the accounting for subordinated liabilities of brokers and dealers.

Mandatorily Redeemable Preferred Stocks and Hybrid Preferred Securities

25. Surplus notes and mandatorily redeemable preferred stocks are similar in that both are subordinated to other claims and because of the terms of redemption as prescribed by the instrument; once issued, redemption is outside the control of the issuer. AcSEC concluded that although practice is to show mandatorily redeemable preferred stock in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC was not persuaded that surplus notes, an instrument that meets all the characteristics of a liability, should be required or permitted to be displayed other than as a liability.

26. Hybrid preferred securities such as monthly and quarterly income preferred securities (MIPS/QUIPS) are securities issued by a special-purpose entity that lends the proceeds to its controlling company. AcSEC concluded that although the practice is to show hybrid preferred securities in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC concluded that surplus notes meet all of the characteristics of a liability and to record surplus notes in a separate category between liabilities and equity outside of liabilities would not provide users with as relevant information.

Income Statement Presentation

27. Because surplus notes are presented on the balance sheet as liabilities, interest payments on surplus notes should be recorded as interest expense through operations. This treatment is consistent with current accounting practice for interest expense on debt.

Appendix R

Statement of Position 97-3

Accounting by Insurance and Other Enterprises for Insurance-Related Assessments

December 10, 1997

Issued by the
Accounting Standards Executive Committee

NOTICE TO READERS

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) provides guidance on accounting by insurance and other enterprises for assessments related to insurance activities. The SOP provides—

- Guidance for determining when an entity should recognize a liability for guaranty-fund and other insurance-related assessments.
- Guidance on how to measure the liability. It allows for the discounting of the liability if the amount and timing of the cash payments are fixed or reliably determinable.
- Guidance on when an asset may be recognized for a portion or all of the assessment liability or paid assessment that can be recovered through premium tax offsets or policy surcharges.
- Requirements for disclosure of certain information.

This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged. Previously issued annual financial statements should not be restated. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, should an entity adopt the SOP prior to the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Entities subject to insurance-related assessments should report the effect of initially adopting this SOP in a manner similar to the reporting of a cumulative effect of a change in accounting principle. (Refer to paragraph 20 of Accounting Principles Board [APB] Opinion No. 20, *Accounting Changes.*)

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (*a*) a prospectus for a project to develop a document, (*b*) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (*c*) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

a. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

b. The proposal will result in an improvement in practice.

c. The AICPA demonstrates the need for the proposal.

d. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Accounting by Insurance and Other Enterprises for Insurance-Related Assessments

Introduction

1. Insurance enterprises as well as noninsurance entities are subject to a variety of assessments related to insurance activities, including those by state guaranty funds and workers' compensation second-injury funds. Some entities may be subject to insurance-related assessments because they self-insure against loss or liability. Current accounting practice is diverse among entities subject to such insurance-related assessments and related recoveries. Some of the diversity is a result of fundamental differences in the methods for assessing entities. Nevertheless, similar assessments are not being accounted for comparably among entities. A number of entities account for assessments on a pay-as-you-go (cash) basis, whereas others account for assessments on an accrual basis. Furthermore, the methods for accrual are varied.

2. As the prevalence and magnitude of guaranty-fund and other insurance-related assessments have increased, concern about the diversity in practice also has increased. This Statement of Position (SOP) provides guidance on accounting by entities subject to insurance-related assessments and was undertaken to reduce diversity in practice, improve the comparability of the amounts reported, and improve disclosures made by entities subject to guaranty-fund and other insurance-related assessments.

Background Information

Guaranty-Fund Assessments

3. States have enacted legislation establishing guaranty funds. The state guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations, subject to prescribed limits, of insolvent insurance enterprises. The assessments are generally based upon premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. At least one state, however, assesses entities prior to insolvencies.

4. State guaranty funds use a variety of methods for assessing entities. This SOP identifies the following four primary methods of guaranty-fund assessments.

a. *Retrospective-premium-based assessments*. Guaranty funds covering benefit payments of insolvent **life, annuity, and health insurance enterprises** typically assess entities based on **premiums written** or received in one or more years *prior* to the year of insolvency.[1] Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.

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[1] Terms defined in the glossary are set in boldface type the first time they appear in this SOP.

b. *Prospective-premium-based assessments.* Guaranty funds covering claims of insolvent **property and casualty insurance enterprises** typically assess entities based on premiums written in one or more years *after* the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

c. *Prefunded-premium-based assessments.* At least one state uses this kind of assessment to cover claims of insolvent property and casualty insurance enterprises. This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed prior to any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.

d. *Administrative-type assessments.* These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency. These assessments are generally expensed in the period assessed and are not addressed further in this SOP.

5. State laws often allow for recoveries of guaranty-fund assessments by entities subject to assessments through such mechanisms as **premium tax offsets**, policy surcharges, and future premium rate structures.

Other Insurance-Related Assessments

6. Entities are subject to a variety of other insurance-related assessments. Many states and a number of local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (*a*) to fund operating expenses of state insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (*b*) to fund second-injury funds.[2]

7. The primary methods used to assess for these other insurance-related assessments are the following.

a. *Premium-based.* The assessing organization imposes the assessment based on the entity's written premiums.[3] The base year of premiums is generally either the current year or the year preceding the assessment.

b. *Loss-based.* The assessing organization imposes the assessment based on the entity's **incurred losses** or paid losses in relation to that amount for all entities subject to that assessment in the particular jurisdiction.

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[2] Second-injury funds provide reimbursement to insurance carriers or employers for workers' compensation claims when the cost of a second injury combined with a prior accident or disability is greater than what the second accident alone would have produced. The employer of an injured or handicapped worker is responsible only for the workers' compensation benefit for the most recent injury; the second-injury fund would cover the cost of any additional benefits for aggravation of a prior condition or injury. The intent of the fund is to help insure that employers are not made to suffer a greater monetary loss or increased insurance costs because of hiring previously injured or handicapped employees.

[3] The assessing organization may be at the state, county, municipality, or other such level.

Scope

8. This SOP applies to all entities that are subject to guaranty-fund and other insurance-related assessments.[4, 5]

9. Assessments covered by this SOP include any charge mandated by statute or regulatory authority that is related directly or indirectly to underwriting activities (including self-insurance), except for income taxes and premium taxes. This SOP does not apply to amounts payable or paid as a result of reinsurance contracts or arrangements that are in substance reinsurance, including assumed reinsurance activities and certain **involuntary pools** that are covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*

Conclusions

Reporting Liabilities

10. Entities subject to assessments should recognize liabilities for insurance-related assessments when all of the following conditions are met.

a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.

b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.

c. The amount of the assessment can be reasonably estimated.

Probability of Assessment

11. Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to a formal determination of insolvency.[6] Prefunded guaranty-fund assessments and premium-based administrative-type assessments (as defined in paragraph 4), are presumed probable when the premiums on which the assessments are expected to be based are written. Loss-based administrative-type and second-injury fund assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

Obligating Event

12. Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an

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[4] Some entities are subject to insurance-related assessments because they self-insure against loss or liability. For example, one state specifies that self-insurers of workers' compensation should use as a base for assessment the amount of premium the self-insurer would have paid if it had insured its liability with an insurer for the previous calendar year.

[5] This SOP does not apply to assessments of depository institutions related to bank insurance and similar funds.

[6] For purposes of this SOP, a formal determination of insolvency occurs when an entity meets a state's (ordinarily the state of domicile of the insolvent insurer) statutory definition of an insolvent insurer. In most states, the entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation.

insolvency) may not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment identified in this SOP.

13. For premium-based assessments, the event that obligates the entity is generally writing the premiums or becoming **obligated to write** or renew (such as multiple-year, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event. Regulatory practice would be determined based on the stated intentions or prior history of the insurance regulators.

14. For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

Ability to Reasonably Estimate the Liability

15. One of the conditions in FASB Statement No. 5, *Accounting for Contingencies,* for recognition of a liability is that the amount can be reasonably estimated. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provides that some amount of loss can be reasonably estimated when available information indicates that the estimated amount of the loss is within a range of amounts. When no amount within the range is a better estimate than any other amount, the minimum amount in the range shall be accrued.

16. Entities subject to assessments may be able to obtain information to assist in estimating the total guaranty-fund cost or the following years' assessments, as appropriate, for an insolvency from organizations such as the state guaranty fund associations, the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF). An entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of an insurance enterprise's future assessments.

17. If a noninsurance entity's assessments are based on premiums, it may be necessary to consider the amount of premium the self-insurer would have paid if it had insured its liability with an insurer. If a noninsurance entity's assessments are based on losses, it should consider the losses that have been incurred by the company when determining the liability. Most often, assessments that have an impact of noninsurance entities that self-insure workers' compensation obligations are for second-injury funds. Second-injury funds generally assess insurance entities and self-insurers based on paid losses. A noninsurance entity may develop an accrual for its second-injury liability based on one or more of the following: (*a*) the ratio of the entity's prior period paid workers' compensation claims to aggregate workers' compensation claims in the state that was used as a basis for previous assessments, (*b*) total fund assessments in prior periods, or (*c*) known changes in the current period to either the number of employees self-insured by the entity or the number of workers who are the subject of recoveries from the second-injury fund that might alter total fund assessments and the entity's proportion of the total fund assessments.

18. Estimates of loss-based assessments should be consistent with estimates of the underlying incurred losses and should be developed based on enacted laws or regulations and expected assessment rates.

19. Estimates of some insurance-related assessment liabilities may be difficult to derive. The development or determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment. Examples of uncertainties follow:

- Limitations, as provided by statute, on the amount of individual contract liabilities that the guaranty fund will assume, that cause the guaranty fund associations' liability to be less than the amount by which the entity is insolvent
- Contract provisions (for example, credited rates) that may be modified at the time of the insolvency or alternative payout options that may be offered to contractholders that affect the level and payout of the guaranty fund's liability
- The extent and timing of available reinsurance recoveries may be subject to significant uncertainties
- Alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments
- Certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities)

Because of the uncertainties surrounding some insurance-related assessments, the range of assessment liability may have to be reevaluated regularly during the assessment process. For some ranges, there may be amounts that appear to be better estimates than any other within the range. If this is the case, the liability recorded should be based on the best estimate within the range. For ranges in which there is no such best estimate, the liability that should be recorded should be based on the amount representing the minimum amount in the range.

Application of Guidance

20. A discussion on applying the conclusions in paragraphs 10 through 19 to the methods used to address guaranty-fund assessments and other insurance-related assessments (as described in paragraphs 4 and 7) follows.

a. *Retrospective-premium-based guaranty-fund assessments.* An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

b. *Prospective-premium-based guaranty-fund assessments.* The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based.[7] Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or a similar event. An entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.

In states without such a law or regulatory practice, the event that obligates the entity is the writing of, or becoming obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments should recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

c. *Prefunded-premium-based guaranty-fund assessments.* A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related premiums are written.

d. *Other premium-based assessments.* Other premium-based assessments, as described in paragraph 6, would be accounted for in the same manner as prefunded-premium-based guaranty-fund assessments.

e. *Loss-based assessments.* An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related loss is incurred.

Present Value

21. Current practice in the insurance industry is to allow, but not require (with limited exceptions, such as pensions and postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability. Similarly, for assessments that meet those criteria, the liability may be recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

Reporting Assets for Premium Tax Offsets and Policy Surcharges

22. When it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges,

[7] For example, multiple-year contracts under which an insurance enterprise has no discretion to avoid writing future premiums.

an asset should be recognized for that recovery in an amount that is determined based on current laws and projections of future premium collections or policy surcharges from **in-force policies**. In determining the asset to be recorded, in-force policies do not include expected renewals of short-duration contracts but do include assumptions as to persistency rates for long-duration contracts. The recognition of such assets related to prospective-premium-based assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the in-force policies. This SOP requires an entity to recognize a liability for prospective-premium-based assessments as the premium is written or obligated to be written by the entity. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective-premium-based assessments should similarly be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

23. For retrospective-premium-based assessments, this SOP requires an entity to recognize a liability for such assessments at the time the insolvency has occurred. Accordingly, to the extent that it is probable that paid or accrued assessments will result in a recoverable amount in a future period from business currently in force considering appropriate persistency rates, an asset should be recognized at the time the liability is recorded.

24. In all cases, the asset shall be subject to a valuation allowance to reflect any portion of the asset that is no longer probable of realization. Considering expected future premiums other than on in-force policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate. An asset shall not be established for paid or accrued assessments that are recoverable through future premium rate structures.

25. The time value of money need not be considered in the determination of the recorded amount of the potential recovery if the liability is not discounted. In instances in which the recovery period for the asset is substantially longer than the payout period for the liability, it may be appropriate to record the asset on a discounted basis regardless of whether the liability is discounted.

26. The policy surcharges referred to in this SOP are those surcharges that are intended to provide an opportunity for assessed entities to recover some or all of the amounts assessed over a period of time. In some instances, there may be policy surcharges that are required as a pass-through to the state or other regulatory bodies, and these surcharges should be accounted for in a manner such that amounts collected or receivable are not recorded as revenues and amounts due or paid are not expensed (meaning, similar to accounting for sales tax).

Disclosures

27. FASB Statement No. 5, FASB Interpretation No. 14, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, address disclosures related to loss contingencies. That guidance is applicable to assessments covered by this SOP. Additionally, if amounts have been discounted, the entity should disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity should disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

Effective Date and Transition

28. This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged. Previously issued annual financial statements should not be restated. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Entities subject to assessments should report the effect of initially adopting this SOP in a manner similar to the cumulative effect of a change in accounting principle. (Refer to paragraph 20 of APB Opinion 20, *Accounting Changes*).

The provisions of this Statement of Position need not be applied to immaterial items.

Basis for Conclusions

29. This section discusses considerations that were deemed significant by members of the AcSEC in reaching the conclusions in this SOP. It provides background information and includes reasons for accepting certain views and rejecting others.

30. The authoritative financial reporting literature does not address explicitly accounting for guaranty-fund and other insurance-related assessments and related premium tax offsets and policy surcharges of entities subject to assessments. AcSEC considered the following pertinent literature in reaching the conclusions in this SOP:

- FASB Statement No. 5, *Accounting for Contingencies*
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*
- FASB Statement No. 87, *Employers' Accounting for Pensions*
- FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
- FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*
- AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*
- AICPA SOP 96-1, *Environmental Remediation Liabilities*
- Emerging Issues Task Force (EITF) Issue No. 87-22, *Prepayments to the Secondary Reserve of the FSLIC*
- EITF Issue No. 91-10, *Accounting for Special Assessments and Tax Increment Financing Entities*
- EITF Issue No. 92-13, *Accounting for Estimated Payments in Connection with the Coal Industry Retiree Health Benefit Act of 1992*
- EITF Issue No. 93-5, *Accounting for Environmental Liabilities*
- EITF Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*
- EITF Topic D-47, *Accounting for the Refund of Bank Insurance Funds and Savings Association Insurance Fund Premiums*
- FASB Concepts Statement No. 6, *Elements of Financial Statements*

- Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 62, *Discounting by Property/Casualty Insurance Companies*
- SEC SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*

Reporting Liabilities

31. FASB Statement No. 5, paragraph 8, requires the accrual of a liability when "a. Information available prior to issuance of the financial statements indicates that it is probable that . . . a liability has been incurred at the date of the financial statements" and "b. The amount of loss can be reasonably estimated." With respect to assessments, FASB Statement No. 5, paragraph 33, states, in part:

> The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:
>
> a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.

FASB Statement No. 5, paragraph 34, states, in part:

> As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for . . . assessments whose underlying cause is an event or condition occurring after the date of financial statements . . . .

32. Therefore, for a liability to be recognized in the financial statements, the underlying cause must have occurred on or before the date of the financial statements. The SOP identifies the obligating event for each kind of assessment, which is the underlying cause.

33. In reaching the conclusions in this SOP concerning when to recognize liabilities for assessments, AcSEC considered the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 and the concept of present obligation:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [*Footnote references omitted.*]

34. To apply the definition of liabilities in paragraph 35 of FASB Concepts Statement No. 6 to assessments, AcSEC considered the underlying cause that creates a present obligation for entities subject to assessments to pay assessments. In order to have a present obligation, the entity must have little or no discretion to avoid the future sacrifice, and the event that obligates the entity must have occurred no later than the date of the financial statements.

35. AcSEC concluded that the fundamental differences in the assessment mechanisms justified identifying different events, depending on the kind of assessment, that would obligate an entity and require recognition of a liability.

Obligating Event

36. More than one event may need to occur before there is a cause for an assessment. AcSEC believes that only when all of the events required to give rise to a cause for action have occurred has the event underlying a liability occurred. AcSEC concluded that the insolvency is the initial event that will give rise to a cause for an assessment, either currently or at some point in the future. The insolvency may or may not also be the final event.

37. If, through the operation of law or regulatory practice, the enterprise has at the time of an insolvency an unavoidable obligation (subject only to the actual imposition of the assessment) to pay for some portion of the insolvency, no further events are required for there to be an underlying cause of a liability. However, if at the moment of the insolvency the enterprise does not, through the operation of law or regulatory practice, have an unavoidable obligation (subject only to the actual imposition of the assessment), then another event is the final event underlying the obligation.

Assessments Based on Premiums

38. For assessments based on premiums written after the insolvency, AcSEC concluded that the writing of premiums on which a potential assessment is based generally should be considered the underlying cause of an entity's obligation to pay cash in the future.[8]

39. In making its decision, AcSEC noted that entities generally have the option of reducing or eliminating their premium-writing activity, thereby reducing or eliminating their assessment. AcSEC was also influenced by the fact that entities subject to assessments that enter a new state or increase market share in a state will be required to pay assessments for insolvencies that occurred before they entered that state or increased their market share. The fact that such entities will have to pay assessments for insolvencies that occurred previously supports the conclusion that the writing of premiums is the underlying cause of the assessments.

40. AcSEC believes that a number of analogies support the conclusions in this SOP. For example, in EITF Issue No. 93-6, a ceding enterprise would recognize a liability for obligatory retrospectively rated contracts only to the extent that it has an obligation to pay cash (or other consideration) to a reinsurer that would not have been required in the absence of experience under the contract. Furthermore, EITF Issue No. 93-6 specifically prohibits ceding companies from recognizing liabilities for amounts expected to be paid in the future that relate to prior catastrophe losses (for example, through increased costs of reinsurance) when no contractual obligation to make such payments exists. AcSEC believes that entities subject to assessments have no obligation to pay assessments unless the premiums on which the assessments are to be based are written.

41. In EITF Issue No. 92-13, the EITF reached a consensus that allowed enterprises with operations in the coal industry to account for their obligations

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[8] As discussed in paragraph 13, some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if the insurance enterprise reduces premium writings in the future. For example, in certain states, an insurance enterprise may remain liable for assessments even though the insurance enterprise discontinues the writing of premiums. In this case, the underlying cause of the liability is not the writing of the premium, but the insolvency.

under the Coal Industry Retiree Health Benefit Act of 1992 (which created a fund to pay benefits related to certain coal-industry benefit trusts that were operating at deficits) as multiemployer pension plans. Guaranty funds are similar to multiemployer pension plans in that each insurance enterprise's payments to the fund are used to satisfy the general obligations of the fund and are not segregated for the benefit of any one enterprise.

42. AcSEC also believes that accounting for claims-made insurance provides an appropriate analogy. In claims-made insurance, the insured event is the reporting, during the term of the policy or within a specified period following the coverage period, to the insurer of a claim for a covered loss. For such policies, entities subject to assessments estimate a liability for unpaid claims based only on claims reported, despite the fact that other losses may have been incurred that eventually may result in claims to that insurance enterprise. The agreement between the insurer and the insured is that the insurance enterprise is not obligated to cover those unreported losses, unless that insurance enterprise is providing coverage under a claims-made policy when the claim is made. Similarly, the substance of the arrangement for most premium-based assessment mechanisms is that an insurance enterprise is obligated to pay assessments only if the premiums on which the assessments are to be based are written.

Assessments Based on Losses

43. For loss-based assessments, AcSEC concluded that the event underlying an insurance enterprise's obligation to pay the assessment is the incurrence of losses on which the assessments are expected to be based (regardless of whether the assessment is based on paid or incurred losses). AcSEC believes that entities subject to assessments have little or no discretion to avoid the future sacrifice once the losses on which the assessments are expected to be based have been incurred. Unlike premium-based assessments, in which the insurance enterprise has the discretion to write or not to write premiums (even if it is unlikely that the insurance enterprise will not write such future premiums), an insurance enterprise is obligated to pay the loss-based assessments once those losses are incurred.

44. AcSEC considered whether it is appropriate to recognize a liability for assessments for administrative-type state funds as the losses on which the assessments are based are incurred by entities. Some have indicated that it is not appropriate to accrue a liability for operating costs of a state fund that have not yet been incurred by the state fund. AcSEC concluded that loss-based assessments for administrative-type funds should be accrued as losses of an entity occur if it is probable that a related assessment will be made. AcSEC believes this is similar to the accounting in FASB Statement No. 60, whereby liabilities for claim adjustment expenses that relate to unpaid claims are accrued before the costs are incurred. Once the losses are incurred, insurance enterprises have little or no discretion to avoid paying the assessment.

Probability of Assessment

45. Although entities subject to assessments may be able to determine that future assessments are probable for some period before a formal determination of insolvency occurs, AcSEC concluded that assessments should not be considered probable until a formal determination of insolvency occurs, unless the assessments are being made by a prefunded guaranty fund. AcSEC believes that the formal determination date is the most objectively determinable measurement date and that requiring its use will foster comparability in reporting. Furthermore, AcSEC believes mere speculation about an insurance enterprise's insolvency should not be considered an accounting event.

Present Value

46. AcSEC believes that recognizing assessment liabilities at their present value provides the most representative measure of the economic substance of the situation. Nevertheless, AcSEC declined to mandate present-value-based measurements while the FASB is still considering the role of present-value-based measurements in financial reporting. For the same reason, this SOP provides no detailed guidance on present-value methodologies and discount rates.

Premium Tax Offsets, Policy Surcharges, and Future Rate Making

47. AcSEC believes that, when it is probable that paid or accrued assessments will result in premium tax offsets or policy surcharges, the recognition of an asset is appropriate based on current laws and projections of future premium collections from in-force policies. No asset should be recognized related to expected new business or renewal of in-force short-duration contracts. In making this determination, AcSEC considered the characteristics of an asset in paragraph 26 of FASB Concepts Statement No. 6, which states, in part:

> An asset has three essential characteristics: (*a*) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (*b*) a particular entity can obtain the benefit and control others' access to it, and (*c*) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.

48. Premium tax offsets, policy surcharges, and the incorporation of assessment costs in future premium rate structures have a similar purpose, that is, to allow entities subject to assessments to recoup some portion of assessment costs. Nevertheless, AcSEC concluded that the ability to include assessments in future premium rate structures should be treated differently from premium tax offsets and policy surcharges. Premium tax offsets and policy surcharges are statutorily provided and generally are not dependent on the ability or intent of an insurance enterprise to take any action. In contrast, there can be no assurance that the future competitive or regulatory environment will allow an insurance enterprise to include assessments in future premium rate structures in such a manner as to result in a recovery of costs. Thus, AcSEC concluded that the statutory ability to include assessment costs in future premium structures should not result in asset recognition and should not be used to reduce current assessment costs.

49. To the extent that paid or accrued guaranty-fund costs are expected to result in premium tax offsets or policy surcharges, AcSEC believes that it is appropriate to consider the recognition of such recoveries as assets. AcSEC believes that the amount of the asset should be limited to expected future premiums related to policies in force at the measurement date. AcSEC considered whether it is appropriate to consider all expected future premiums in establishing such recoveries and concluded that this approach would introduce an inconsistency with AcSEC's decision not to recognize a liability for guaranty-fund and similar assessments that are based on future premiums. Therefore, AcSEC determined that considering all expected future premiums in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

50. AcSEC also considered whether there was an inappropriate inconsistency between requiring the use of persistency assumptions in asset recognition and not for liability recognition in prospective-premium-based assessments (for example, for multiple-year contracts). AcSEC concluded that this treatment was appropriate due to the limited number of instances in which persistency assumptions would be applicable for liability measurement.

Prefunded-Premium-Based Assessments

51. For prefunded-premium-based assessments, as long as such funds do not provide, either by statute or practice, for a return of excess assessments, no asset should be recorded.

Transition

52. AcSEC decided to prohibit the retroactive application of this SOP. AcSEC recognizes the benefits of comparative financial statements but believes that the necessary information for entities subject to assessments to create for prior periods the necessary estimates of liabilities for future assessments and of the timing and amounts of cash flows would not be readily available.

APPENDIX A

Illustration of Computation of Assessment Liabilities

Example 1—Prospective-Premium-Based Assessment[1]

Scenario

As a result of insolvencies in prior years, ABC Property & Liability Insurance Company (ABC) expects to be assessed in the future by the guaranty fund in a state where it writes premiums. Any such assessments will be limited to 2 percent of premium writings in the prior year and are recoverable through premium tax offsets on a ratable basis over the five-year period following the year of each assessment.

Although it does not expect to do so, ABC is free to cease writing the lines of business that are subject to the guaranty-fund assessments.

As of December 31, 19X0, ABC has neither paid nor received a notice of an assessment related to the insolvencies. Based on communications from the state guaranty association, ABC expects to receive an assessment in 19X1, which is allocated among entities based on 19X0 market share, for at least 1 percent of 19X0 premiums that are subject to the assessment. A best estimate cannot be determined, and no amount within the range of estimates (meaning, from 1 to 2 percent of 19X0 premiums) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

Result

As of December 31, 19X0, ABC should recognize a liability equal to 1 percent of the premiums written in 19X0 that are subject to the assessment. No additional liability should be recognized, and no asset related to the premium tax offset should be recognized. Disclosure of the loss contingency of up to an additional 1 percent of the subject premiums should be considered.

Discussion

ABC would recognize a liability only for those future assessments it is obligated to pay as a result of the premiums written. Because ABC is not obligated to write any future premiums, its liability is limited to that related to premiums written in 19X0. Because no amount within the range of estimates is a better estimate than any other amount, the minimum amount in the range is accrued. Further, because the premium tax offset is realizable only on business that will be written in the future (that is, 19X2 and subsequent years), no asset or receivable is recognized as of December 31, 19X0.

Example 2—Retrospective-Premium-Based Assessment

Scenario

As a result of an insolvency that occurred during 19X0, DEF Life and Health Insurance Company (DEF) expects to be assessed in the future by the guaranty

[1] This kind of assessment is considered prospective since the assessment relates to premium written subsequent to the insolvency.

fund in a state where it has written business. Any such assessment will be based on DEF's average market share, determined based on premiums that are subject to the assessment for the three years prior to the insolvency, and limited to 2 percent of the average annual subject premiums for the three years prior to the insolvency. Further, such assessments are recoverable through premium tax offsets over the five-year period following the year of payment for each assessment.

As of December 31, 19X0, DEF has not paid or received a notice of an assessment related to the insolvency. Based on initial input from the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) and experience with other insolvencies, DEF assumes that the first assessment will not be made until 19X3 and that it will take three to five annual assessments in order for the guaranty fund to be able to meet its obligations. Based on the estimated nationwide cost of the insolvency and the distribution of the insolvent company's business, DEF estimates that its assessment will be at least 1 percent of the average annual premiums that are subject to the assessment. No amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, therefore the minimum amount in the range should be accrued.

Result

As of December 31, 19X0, DEF should recognize a liability for three years of assessments at 1 percent of the average annual premiums that are subject to the assessment (that is, the assessments expected in 19X3, 19X4, and 19X5). Disclosure of the loss contingency for additional assessments (meaning, in 19X6 and 19X7) or assessment of greater than 1 percent of the average annual premiums that are subject to the assessment should be considered. An asset related to premium tax offsets that are available on accrued assessments would be recorded provided there were sufficient premium taxes based on business in force at December 31, 19X0 (with assumed levels of policy retention) to allow realization of the asset.

The resulting recognized liability and asset are as follows (shown on both a discounted and undiscounted basis, based on paragraphs 21 and 25, discounting is optional), assuming average annual subject premiums of $100,000 for the three years prior to the insolvency.

Schedule of Assessments and Premium Tax Offsets

	Recorded At	Cash Payments									
	12/31/19X0	19X1	19X2	19X3	19X4	19X5	19X6	19X7	19X8	19X9	20X0
Assessments											
19X3 Assessment				1,000							
19X4 Assessment					1,000						
19X5 Assessment						1,000					
Total	3,000			1,000	1,000	1,000					
Premium Tax Offset											
19X3 Assessment (1)					200	200	200	200	200		
19X4 Assessment (1)						200	200	200	200	200	
19X5 Assessment (1)							200	200	200	200	200
Total	3,000				200	400	600	600	600	400	200
Present value of assessments											
at 12/31/19X0 (2)	2,470										
Present value of Premium											
Tax Offset at 12/31/19X0 (2)	2,139										

(1) Assumes that, based upon anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset.

(2) Discounted at 5 percent, assuming all assessments are paid and offsets realized at the end of each year.

Discussion

DEF would record a liability for all future assessments related to the insolvency. Because no amount within the range of estimates (meaning, from 1 to 2 percent of the average annual premiums for three to five years) is a better estimate than any other amount, the minimum amount in the range (meaning, 1 percent per year for three years of assessments) is accrued.

Since it is assumed that based upon the anticipated levels of policy retention from the business in force at December 31, 19X0, there will be sufficient premium to realize the premium tax offset, the premium tax offset is recorded.

Example 3—Loss-Based Assessment

Scenario

GHI Industrial Company (GHI) is self-insured for workers' compensation and therefore participates in the second injury fund in the state where it conducts operations. GHI is entitled to recover from the fund for some or all of the indemnity claims for previously injured workers. GHI is also subject to annual assessments (maximum of 1 percent per year) on indemnity claims paid each year.

Assessment rates have been climbing steadily, from 0.6 percent five years ago to 0.75 percent in 19X0.

Results

As of December 31, 19X0, GHI should have an assessment liability recognized for 0.75 percent of its liability for the payment of future indemnity claims, unless there was information to support the assessment rate being reduced or the assessments being eliminated in the future. Disclosure of the loss contingency of up to an additional 0.25 percent of the liability for the payment of future indemnity claims should be considered.

Discussion

GHI would recognize a liability based on the current assessment rate, unless there was clear evidence that the rate would change. The liability would be based on the entire liability base that was subject to the assessment.

APPENDIX B

Discussion of Comments Received on the Exposure Draft

An exposure draft of a proposed statement of position (SOP), *Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments*, was issued for public comment on December 5, 1996, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-four comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following four areas:

1. Reporting assets and policy surcharges
2. Estimation of the assessment liability
3. Accounting for prospective-premium-based assessments
4. Scope

Reporting Assets and Policy Surcharges

The guidance in the exposure draft on reporting assets and policy surcharges caused some confusion. Several respondents requested clarification about the kind of entity that would recognize assets for premium tax offsets and policy surcharges. AcSEC clarified the guidance to explain how an asset should be accounted for when it is probable that a paid or accrued assessment will result in an amount that is expected to be recoverable.

Estimation of the Assessment Liability

Several respondents commented that they do not believe a liability can be reasonably estimated by an entity for guaranty-fund assessments because the entity will not have the necessary information to estimate the amount of loss. These respondents commented that a determination of estimates is particularly difficult for guaranty-fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment because of such factors as alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments and certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities). AcSEC believes that, although it may be difficult to calculate a point estimate in certain circumstances (see paragraph 19), in the majority of cases, enough information is available to calculate a range of estimates. Further, in the case of prospective-premium-based assessments, the liability to be recorded is related only to premiums written or obligated to be written, rather than to all expected future premiums.

Accounting for Prospective-Premium-Based Assessments

The exposure draft contained an alternative view on accounting for prospective-premium-based assessments, which discussed that a minority of AcSEC believed that the insolvency should be considered the underlying cause of an entity's obligation to pay future assessments, irrespective of the basis used to determine the amount due from each insurance enterprise subject to the assessment. The majority of respondents did not support this minority view. AcSEC continues to believe that the writing of the premium on which potential assessments are expected to be based is the underlying cause of an entity's obligation to pay cash in the future.

Scope

Because entities other than insurance enterprises are assessed insurance-related assessments, the scope of the exposure draft included all reporting entities. Although some noninsurance entities requested to be excluded from the scope, most of the respondents believe that both insurance enterprises and noninsurance enterprises would have sufficient information to recognize a liability for the assessments covered in the SOP.

Glossary

Incurred losses. Losses paid or unpaid for which the company has become liable during a period.

In-force policies. Policies effective before a specified date that have not yet expired or been canceled.

Involuntary pools. A residual market mechanism for insureds who cannot obtain insurance in the voluntary market.

Life, annuity, and health insurance enterprise. An enterprise that may issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life and health insurance enterprises may be either stock or mutual organizations.

Obligated to write. If an entity has no discretion to cancel a policy because of legal obligation under state statute or contract terms, or regulatory practice and is required to offer or issue insurance policies for a period in the future.

Premium tax offsets. Offsets against premium taxes levied on insurance companies by states.

Premiums written. The premiums on all policies a company has issued in a period.

Property and casualty insurance enterprise. An enterprise that issues insurance contracts providing protection against either (1) damage to or loss of property caused by various perils, such as fire and theft or (2) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises may be either stock or mutual organizations.

Appendix S

Statement of Position 98-6

Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association

April 9, 1998

Issued Under the Authority of the Auditing Standards Board
American Institute of Certified Public Accountants

NOTE

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of Statements on Standards for Attestation Engagements to engagements to report on management's assessment pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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SUMMARY

This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the AICPA Statement on Standards for Attestation Engagements to assist an entity in meeting the requirements of the Insurance Marketplace Standards Association (IMSA) program (the IMSA program). IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its *Assessment Handbook* and requirements.

This SOP is effective for independent assessments with IMSA report dates after January 31, 1998.

Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association

Introduction and Background

1. Within the past several years, the life insurance industry has experienced allegations of improper market conduct practices such as questionable sales practices and potentially misleading policyholder illustrations. These allegations have triggered regulatory scrutiny, class action litigation, significant monetary settlements, and negative publicity related to market conduct issues. As a result, the industry is taking steps to promote a higher standard of ethical behavior that it hopes will reverse the negative perceptions held by many customers. In that regard, the American Council of Life Insurers (ACLI), the largest life insurance trade organization, has established the Insurance Marketplace Standards Association (IMSA) as a nonaffiliated membership organization with its own board of directors composed of chief executives of life insurance companies. IMSA seeks to encourage and assist participating life insurance entities (hereinafter referred to as entities) in the design and implementation of sales and marketing policies and procedures that are intended to benefit and protect the consumer. Entities that desire to join IMSA will be required to adopt the IMSA Principles of Ethical Market Conduct (the Principles) and the Code of Ethical Market Conduct (the Code) and Accompanying Comments and respond affirmatively to an assessment questionnaire (the Questionnaire). Each prospective member also will be required to conduct a self-assessment to determine that it has policies and procedures in place that will enable it to respond affirmatively to the Questionnaire. An entity's self-assessment responses to the Questionnaire will need to be validated by an independent examination of the self-assessment. On obtaining an unqualified third-party assessment report, entities will be eligible for IMSA membership. Membership in IMSA is valid for a three-year period. Members are permitted to use IMSA's logo subject to rules set forth by IMSA for advertising and other promotional activities. The assessment process is intended to encourage entities and help them continually review and modify their policies and procedures in order to improve their market conduct practices and those of the industry and to strengthen consumer confidence in the life insurance business.

2. Certified public accountants in the practice of public accounting (herein referred to as practitioners as defined by Statement on Standards for Attestation Engagements [SSAE] No. 1, *Attestation Standards* [AICPA, *Professional Standards*, vol. 1, AT sec. 100, "Attestation Engagements"]), may be engaged to examine and/or provide various consulting services related to the entity's self-assessment. This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the American Institute of Certified Public Accountants (AICPA) SSAEs to assist an entity in meeting the requirements of the IMSA Life Insurance Ethical Market program (the IMSA program). As described herein, IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its *Assessment Handbook* and requirements.

Scope

3. This SOP applies to engagements to report on an entity's assertion that the affirmative responses to the Questionnaire relating to the IMSA Principles and Code and Accompanying Comments are based on policies and procedures in place at the IMSA report date. Reporting on assertions made in connection with the IMSA program are examination engagements that should be performed under SSAE No. 1 (AT sec. 100).

Overview of the IMSA Life Insurance Ethical Market Conduct Program

Principles of Ethical Market Conduct

4. The Principles consist of six statements that set certain standards with respect to the sale and service of individually sold life and annuity products. The Principles that the entity is required to adopt are as follows:

Principle 1

To conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself.

Principle 2

To provide competent and customer-focused sales and service.

Principle 3

To engage in active and fair competition.

Principle 4

To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.

Principle 5

To provide for fair and expeditious handling of customer complaints and disputes.

Principle 6

To maintain a system of supervision and review that is reasonably designed to achieve compliance with these Principles of Ethical Market Conduct.

5. IMSA developed the Code of Ethical Market Conduct to expand the Principles of Ethical Market Conduct to the operating level and to identify the attributes of the sales, marketing, and compliance systems that IMSA believes should support each of the Principles.

6. To further expand on the Principles and Code, IMSA developed Accompanying Comments, which further define the intention of the Principles and Code and, in some instances, provide examples of implementation.

IMSA Assessment Questionnaire

7. As noted above, IMSA developed the Questionnaire to provide prospective members with uniform criteria to demonstrate for self-assessment purposes that they have policies and procedures in place that meet the objective of the questions in the Questionnaire.

Insurance Marketplace Standards Association Membership and Certification Process

8. Participation in the IMSA program requires an entity to adopt the Principles and Code and to undertake a two-step assessment process. First, an entity conducts a self-assessment, using the Questionnaire and *Assessment Handbook*, with the objective of concluding that it can respond affirmatively to every question in the Questionnaire in conformity with the criteria set forth in IMSA's Principles, Code, and Accompanying Comments. Second, an independent assessor from a list of IMSA-approved assessors examines the self-assessment materials to determine whether the entity has a reasonable basis for its affirmative responses to the Questionnaire.

9. Once the assessment process is complete, the entity submits its IMSA Membership Application (the application) and Self-Assessment Report. The Self-Assessment Report states that the entity has adopted the Principles and Code, has conducted a self-assessment of its policies and procedures, and has determined that the answer to each of the questions in the Questionnaire is "yes" in conformity with the *Assessment Handbook*. The entity also submits an unqualified examination report from an IMSA-approved independent assessor.

IMSA Independent Assessor Application Process and Required Training

10. IMSA will accept independent assessor reports only from those assessors that have been preapproved by IMSA. To become an independent assessor, a candidate is required to submit an IMSA Independent Assessor Application that requires that the candidate meet specific educational and professional requirements established by the IMSA board of directors. IMSA also requires that all independent assessors attend IMSA training as outlined by the board of IMSA. Independent assessors may be of various occupations or professional disciplines, including certified public accountants.

IMSA Assessment Handbook

11. IMSA developed an *Assessment Handbook* (the Handbook or the IMSA Handbook) to assist companies in the implementation of the IMSA program and provide guidance to independent assessors. Entity personnel and independent assessors should use the Handbook to gain an understanding of the assessment process and as a source of information for performing an assessment. The Handbook is intended for companies of all sizes regardless of the means by which they distribute individually sold life and annuity products. IMSA acknowledges that this is a new program that will evolve over time. Therefore, the Handbook may be revised as companies and independent assessors provide IMSA with suggestions for improvement. Practitioners should ensure that they are utilizing the most current version of the Handbook in planning and performing their work.

Conclusions

Planning the Engagement

12. To satisfy IMSA program requirements, practitioners need to perform an examination engagement pursuant to SSAE No. 1 (AT sec. 100), which states that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attest function and have adequate knowledge in life insurance market conduct and the IMSA program to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

13. The examination should be made in accordance with standards established by the AICPA, including obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based. To be acceptable to IMSA, the engagement also should be performed in accordance with the criteria set forth in the IMSA Handbook. This SOP is intended to provide neither all the required criteria set forth in the IMSA Handbook nor all the applicable standards established by the AICPA.

14. In accordance with SSAE No. 1 (AT sec. 100.33–.35) and the Handbook, a practitioner performing the examination should supervise the engagement team, which involves directing the efforts of the engagement team in accomplishing the objectives of the engagement and determining whether the engagement objectives were met. If the practitioner is not an IMSA-approved independent assessor, such an assessor should be a member of the engagement team with responsibility for, among other things, assisting the practitioner in performing these functions.

15. The engagement team should be informed of its responsibilities, including the objectives of the procedures that they are to perform and matters that may affect the nature, extent, and timing of such procedures. The work performed by each member of the engagement team should be reviewed to determine if it was adequately performed.

16. IMSA, through its Handbook, has adopted a methodology to foster a uniform determination by entities and their independent assessor on whether policies and procedures are in place. The Handbook requires the following three aspects be present: approach, deployment, and monitoring. (See appendix B, paragraph B-2, for further discussion.)

Establishing an Understanding With the Client

17. The practitioner should consider the risks associated with accepting an engagement to examine and report on an entity's assertion about its responses to the IMSA Questionnaire. The practitioner should establish an understanding with the client regarding the services to be performed. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, limitations of the engagement, provision for changes in the scope of the engagement, and the expected form of the report. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C contains a sample engagement letter that may be used for this type of engagement.

Assessments of Attestation Risk

18. The practitioner should evaluate the attestation risk that policies and procedures may not be in place to support affirmative responses to the Questionnaire and should consider this risk in designing the attest procedures to be performed. In examining whether policies and procedures are in place, the practitioner determines whether the policies and procedures have been adopted and are in operation and whether such policies and procedures satisfy the six components required by IMSA for the entity to respond affirmatively to each question, as discussed in appendix B. Whether an entity has policies and procedures in place does not encompass whether those policies and procedures operated effectively as of a particular date, or over any period of time, to ensure compliance with the Principles, Code, and Accompanying Comments or about whether the entity or its employees have complied with applicable laws and regulations.

19. Examples of risk considerations that may affect the nature, timing, and extent of testing procedures are listed in appendix A. Not all the examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, distribution channels, product lines, or sales volume. In determining the examination procedures to be performed, practitioners should assess the impact that those risk considerations, individually and in combination, may have on attestation risk.

20. Before performing attestation procedures, the practitioner should be adequately trained and should obtain an understanding of the entity's overall operations and market conduct practices, as well as its policies and procedures that have been identified in the self-assessment as supporting its affirmative responses to the Questionnaire. In addition, the practitioner should obtain an understanding of the operation and history of the entity's distribution systems and products sold and of sales volume by product and distribution system. The practitioner should also obtain an understanding of the entity's past market conduct issues and related corrective measures.

Evidential Matter

21. In an examination engagement performed under the attestation standards, the practitioner's objective is to accumulate sufficient evidence to limit attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. In such an engagement, the practitioner should select from all available procedures any combination that can limit attestation risk to such an appropriately low level. Accordingly, in an examination engagement it is necessary for a practitioner's procedures to go beyond reading relevant policies and procedures and making inquiries of appropriate members of management to determine whether the policies and procedures supporting affirmative responses to the Questionnaire were in place. Examination procedures should also include verification procedures, such as inspecting documents and records, confirming assertions with employees or agents, and observing activities. See appendix B for examples of illustrative procedures.

22. As outlined in the Handbook, the entity should provide the practitioner with adequate information for the practitioner to obtain reasonable assurance that there is a basis for an affirmative response to each of the questions in the Questionnaire. The AICPA's concept of reasonable assurance in the context of an attestation engagement is set forth in SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400.13), and SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500.30). These concepts are consistent with IMSA's concept of reasonable assurance as defined in the Handbook.[1]

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[1] *Reasonable (assurance)* is defined in the Handbook as follows: "In the context of the IMSA program documents, the term *reasonable* is used to modify assurance, as an acknowledgment that it is virtually impossible to provide absolute and certain assurance that an event will happen (e.g., that a policy will address every possible circumstance, or that procedures will be applied without exception). *Reasonable*, as a qualifier, suggests that there exists a standard in both design and performance, and that such a standard, while conforming to the judgment or discernment of a knowledgeable person, is neither excessive nor extreme."

23. In an examination of management's assertion about an entity's affirmative responses to the Questionnaire, the practitioner's evaluation of sufficiency and competency of evidential matter should include consideration of (*a*) the nature of management's assertion and the related indicators used to support such assertions, (*b*) the nature and frequency of deviations from expected results of applying examination procedures, and (*c*) qualitative considerations, including the needs and expectations of the report's users.

Reporting Considerations

24. SSAE No. 1 (AT sec. 100) defines an attest engagement as one in which a practitioner is engaged to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. The accompanying affirmative responses to the questions in the Questionnaire are written assertions of the entity. When a practitioner is engaged by an entity to express a written conclusion about management's assertions about its policies and procedures, such an engagement involves a written conclusion about the reliability of an assertion that is the responsibility of the entity. The entity is responsible for the design, implementation, and monitoring of the policies and procedures upon which the responses to the Questionnaire are based.

25. Self-assessment is based in part on criteria set forth in the IMSA Handbook, which is prepared by an industry organization for the specific use of its members. Such criteria are not suitable for general distribution reporting. Accordingly, the independent accountant's report should contain a statement that it is intended solely for the information and use of the entity's board of directors and management as well as IMSA.

26. IMSA has adopted a uniform assessment report that all independent assessors (regardless of professional discipline) are required to use when reporting on the results of an independent assessment. IMSA has indicated that deviations from its standard report format, except as discussed below, will not be accepted. The following is an illustration of an independent accountant's report on a company's assertion relating to its affirmative responses to the IMSA Questionnaire. The third paragraph in the following report deviates from the IMSA format, where the practitioner specifies that the examination was made in accordance with standards established by the AICPA, and refers to those standards before referring to the criteria set forth in the IMSA Handbook. The other deviation is that the report is titled "Independent Accountant's Report" rather than "Independent Assessor Report." Representatives of IMSA have indicated that they will accept only these deviations for reports issued by practitioners.

Independent Accountant's Report

To [*name of insurer*] Board of Directors and the Insurance Marketplace Standards Association:

We have examined management's assertion that the affirmative responses of [*name of insurer*] to the Questionnaire relating to the Principles of Ethical Market Conduct and the Code of Ethical Market Conduct and Accompanying Comments for individually sold life and annuity products, adopted by the Insurance Marketplace Standards Association ("IMSA"), are based on policies and procedures in place as of [*the IMSA report date*]. The Company is responsible for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire are based.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and in accordance with the criteria set forth in the IMSA *Assessment Handbook*, and included obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination was not designed to evaluate whether the policies and procedures, upon which the Company's responses to the Questionnaire are based, have or will operate effectively, nor have we evaluated whether or not the Company has or will comply with applicable laws or regulations. Accordingly, we do not express an opinion or any other form of assurance thereon.

In our opinion, management's assertion that the affirmative responses to the Questionnaire are based on policies and procedures in place as of [*the IMSA report date*] is fairly stated, in all material respects, based upon the criteria set forth in the Principles of Ethical Market Conduct, the Code of Ethical Market Conduct and Accompanying Comments, and the *Assessment Handbook*.

This report is intended solely for the information and use of the board of directors and management of the Company and the Insurance Marketplace Standards Association and should not be used for any other purpose.

____

[*IMSA Report Date; see paragraph 28*]

____

[*Company (Insurer)*]

____

[*Name of Independent Assessor; see paragraph 27*]

____

[*Signature of Independent Accountant or Firm*]

____

[*Date of Signature; see paragraph 29*]

Note: In any instance where an alternative indicator is used to support an affirmative answer to any question in the Questionnaire, such alternative indicator must be fully set forth in an attachment to this Assessor Report (see paragraph 30).

Elements of the Report

27. *Signatures and Identification of the Independent Assessor.* IMSA prefers that the independent assessor sign his or her name on the report. However, many AICPA member firms require that a manual or printed signature of the firm name be presented on the face of the report and prohibit a member of the firm from signing the report as an individual. Although IMSA will accept this practice, it requires the identification on the face of the independent accountant's report of the IMSA-approved independent assessor who actively participated in and supervised relevant portions of the engagement on behalf of the firm. In addition, in circumstances where the IMSA-approved independent assessor does not sign the report as an individual, IMSA requires an affirmation from the independent assessor to be attached to the independent accountant's report. A sample affirmation follows:

Affirmation of Independent Assessor

I, [*print name*], affirm that I have reviewed the attached Independent Accountant's Report on management's assertions regarding the IMSA program for [*insurer*] as of [*IMSA report date*] and that I was the Independent Assessor responsible for supervising relevant portions of the assessment identified herein.

[*Signature*]
[*Date of Signature*]

28. *IMSA Report Date.* The IMSA report date referred to in the independent accountant's report is the date of the self-assessment and the date to which the entity and the independent assessor have agreed as the point in time which the policies and procedures supporting the affirmative response to the Questionnaire are in place. Due care should be taken to ensure that representations made by management on the basis of a self-assessment are current as of the IMSA report date. If a significant amount of time has elapsed between the date of the performance of the practitioner's procedures on certain questions and the IMSA report date, due care should be taken to ensure that policies and procedures were in place as of the IMSA report date.

29. *Date of Signature.* The date of signature is the date fieldwork is completed. Changes in the policies and procedures, personnel changes, or other considerations that might significantly affect responses to the Questionnaire may occur subsequent to the IMSA report date but before the date of signature or the date when the report is issued. The practitioner should obtain management's representations relating to such matters and perform such other procedures regarding subsequent events considered necessary in the circumstances. The practitioner has no responsibility to perform examination procedures or update his or her report for events subsequent to the date when the report is issued; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of a report on an audit of financial statements described in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report").

30. *Alternative Indicators.* A list of indicators in the Handbook corresponds to each of the questions in the Questionnaire and lists possible policies and procedures identified by IMSA that an entity can have in place to be able to respond affirmatively to a question. A company must support each "yes" response to a question by the selection of indicators sufficient to meet the six required components and to meet the objective of each question. IMSA has established limitations on the use of indicators other than those contained in the Handbook. Alternative indicators that are used as support for an affirmative response to a question in the Questionnaire may require preapproval by IMSA in certain situations, as noted in the Handbook. It will be necessary for the practitioner to evaluate whether an alternative indicator used by the entity supports an affirmative response to the question. The alternative indicators should be disclosed by the practitioner to IMSA in the basic independent accountant's report as an attached appendix, and an explanatory paragraph should be added to the standard independent accountant's report in paragraph 26. The following is an example of a paragraph that should be included in the examination report when alternative indicators are used by management. The paragraph should precede the opinion paragraph.

Management's assertion supporting an affirmative response to certain questions is supported by the use of alternative indicators, as that term is defined in the IMSA Handbook. The attached appendix to this report lists the questions and alternative indicators used by management.

31. *Negative Responses.* IMSA will not grant membership applications to an entity whose application contains a "no" response to any question. In circumstances where no report will be issued to IMSA, management may request the practitioner to report findings to management or the board of directors. In this situation, the practitioner and management should agree on the means and format of such communication and document this understanding in writing.

32. *Working Papers.* The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply. Although it is not possible to specify the form or content of the working papers that a practitioner should prepare in connection with an assessment because circumstances vary in individual engagements, the practitioner's working papers ordinarily should indicate that—

a. The work was adequately planned and supervised.

b. Evidential matter (SSAE No. 1 [AT sec. 100.36–.39]) was obtained to provide a reasonable basis for the conclusion that the policies and procedures underlying the affirmative responses contained in the Questionnaire are in place.

In its required training, IMSA has advised IMSA-approved independent assessors to appreciate the sensitivity of insurers to litigation risks and the production of documents that litigation typically requires. IMSA has reminded assessors and insurers alike that the self-assessment process is designed to demonstrate compliance currently with IMSA assessment criteria and that reports will not be accepted by IMSA unless all questions are answered in the affirmative. Accordingly, IMSA has stated its belief that IMSA-approved assessors will have no need, at least for IMSA's purposes, to maintain documentation of noncompliance with the IMSA assessment criteria currently or in the past.

33. Concern over access to the practitioner's working papers might cause some clients to inquire about working paper requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to the auditing Interpretation "The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.06–.17) for guidance. See the attest Interpretation "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AT sec. 9100.58) for guidance related to providing access to or photocopies of working papers to a regulator in connection with work performed on an attestation engagement.

34. *Management's Representations.* The practitioner should obtain written representation from management—

a. Acknowledging management's responsibility for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire are based and that the affirmative responses to the Questionnaire are based on such policies and procedures in place as of a specific point in time.

b. Stating that management has adopted the Principles and Code, and has performed and made available to the practitioners all documentation related to a self-assessment of the policies and procedures in place as of the IMSA report date upon which the affirmative responses to the Questionnaire are based.

c. Stating that management has disclosed to the practitioner all matters regarding the design, implementation, and monitoring of policies and procedures that could adversely affect the entity's ability to answer affirmatively the questions in the Questionnaire.

d. Describing any related material fraud or other fraud or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire were made.

e. Stating whether there were, subsequent to the date of management's self-assessment (that is, the IMSA report date), any known changes or deficiencies in the design, implementation, and monitoring of the policies and procedures in place, including any personnel changes or other considerations of reference to the IMSA Questionnaire subject matter.

f. Stating that management has disclosed any communication from regulatory agencies, internal auditors, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the IMSA report date (the date of management's assertion) and the date of the practitioner's report (the date of signature).

g. Stating that management has disclosed to the practitioners, orally or in writing, information about past market conduct issues (for example, policyholder complaints or litigation) of relevance to the IMSA Questionnaire subject matter and the related corrective measures taken to support affirmative responses in those areas.

35. Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to preclude an unqualified report suitable for submission to IMSA. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

Effective Date

36. This SOP is effective for independent assessments with IMSA report dates after January 31, 1998. Early application is permissible.

APPENDIX A

Assessment of Attestation Risk

A.1. The following are examples of considerations that may influence the nature, timing, and extent of a practitioner's testing procedures relating to an entity's assertion of its affirmative responses to the Questionnaire. The considerations may also affect a practitioner's decision to accept such an engagement. The examples are not intended to be a complete list.

Management Characteristics and Influence Over the Control Environment

- Management's attitude regarding internal control over sales and marketing practices, which may affect its ability to foster a more comprehensive and effective compliance program
- Management's financial support of the internal resources allocated to the development and maintenance of compliance with the IMSA program through adequate funding, resources, time, etc.
- Management's history of ensuring that sales personnel are qualified, trained, licensed, and supervised
- Management's history and systems for tracking complaint and replacement trends
- Management's ability to generate timely, complete, and accurate information on issues of regulatory concern regarding sales and marketing practices
- The entity's relationship with its current independent assessor, regulatory authorities, or both (The practitioner should gain an understanding of the circumstances surrounding the disengagement of predecessor independent assessors, any issues identified in prior self-assessments or independent assessments, and consider making inquires of predecessor assessors.)
- Consistent application of policies and procedures across product lines and distribution channels (If the entity did not address each distribution channel, product line, or both because it deemed certain ones to be immaterial in terms of premiums earned or in force, or because of low volume of production, the practitioner will need to use his or her professional judgment to assess whether the omitted product lines or distribution channels should have been considered in the entity's self-assessment and assess the impact on his or her ability to opine on management's assertions by exercising that judgment. The definition of the term *appropriate to its size* in the Handbook may also apply.)
- Whether the entity's approach to its self-assessment includes validation of the information it collected to support that policies and procedures are in place

Industry Conditions

- Changes in regulations or laws, such as those governing various products, sales methods and materials, agent compensation, and customer disclosure
- Publicity about sales and marketing practices and increased litigation to seek remedy
- Rapid changes in the industry, such as the introduction of new and complex product offerings or information technology
- The degree of competition or market saturation

Distribution, Sales Volume, and Products

- The diversity of distribution systems
- The relative volume of business for different products and distribution systems
- The length of time that products, distribution systems, or both have been available, used, or both
- Limitations of an entity's ability to assert control over producers
- Compliance training provided by management to its producers and employees involved in the sales process
- The complexity of product offerings
- The targeted markets for various products
- Whether the entity is applying for IMSA membership as a fleet of entities or as an individual entity (If the entity is applying for fleet membership, the independent assessor should plan the engagement to address whether the policies and procedures are in place at each company within the fleet, including newly acquired subsidiaries or affiliates in the fleet.)

Other Considerations

- Issues identified in prior self-assessments, independent assessments, and other services provided
- Findings from recent market conduct examinations conducted by regulatory authorities or internal auditors
- Policyholder concerns expressed through complaints or litigation
- Ratings received from rating agencies

APPENDIX B

Illustrative Procedures

B.1. Examples of illustrative procedures are provided in this appendix. The procedures are organized by the three aspects of each question. Many of these procedures can be used for more than one question. The illustrative procedures are intended to be used as a guide and are not to be considered all-inclusive. Because the objective and the types of policies and procedures for each question will differ according to the methods for establishing, maintaining, communicating, deploying, and monitoring as they differ by entity and for each question, no single methodology for testing can be suggested. Practitioners should use judgment to determine the procedures necessary to be performed to render an opinion. It will be more difficult to obtain objective evidence about some indicators than others. Accordingly, the practitioner should adjust the procedures selected for testing. A challenging aspect of the IMSA program is its application to various distribution channels, including independent producers, and how entities will satisfy questions relating to these various channels. This is because an entity's ability to enforce or encourage producers to use its policies and procedures varies by channel. The practitioner needs to clearly understand how an entity manages each significant distribution channel.

B.2. IMSA has identified three aspects of each question: approach, deployment, and monitoring. The aspects are defined in the glossary of the Handbook as follows:

> *Approach*—A systematic method or means used by the entity to address the requirements of the Principles and Code, as queried by the specific question.
>
> *Deployment*—Refers to the extent to which the entity's approach is actually being applied to the provisions of the Principles and Code.
>
> *Monitoring* —To check routinely and systematically with a view to collecting certain specified categories of information, to investigate and resolve questions concerning anomalous or unexpected information, and to identify the need for or to make recommendations designed to reduce the probability of future anomalies. The Principles, Code, Accompanying Comments, and Questionnaire require that monitoring be performed to provide reasonable assurance that policies accurately reflect management's (or other applicable governing bodies') point of view, that procedures are designed to support those policies, and that procedures are appropriately executed.

Approach

B.3. The two components underlying the first aspect, *approach*, as defined by the Handbook are as follows:

a. Does the insurer have in place policies and procedures that address the objective of the question?

b. Is someone (an individual or a team) responsible for establishing, maintaining, communicating, deploying, and monitoring these policies and procedures?

B.4. The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *approach* aspect:

Examine Documentation

- Obtain and read written policies and procedures to obtain an understanding of—

  a. The policies and procedures that are supposed to be in place and to which distribution systems, products, and markets those policies and procedures apply.

  b. How the policies and procedures respond to the objective of the question.

  c. Who (a person or department) is responsible for establishing, maintaining, communicating, deploying, and monitoring those policies and procedures.

- Examine job descriptions, titles, organization charts, and other communications for those identified as being responsible for the policies and procedures to support the assignment of those responsibilities.

Inquiry

- Through inquiry, obtain an understanding of—

  a. How the policies and procedures are being used in practice.

  b. Who is responsible for the policies and procedures being addressed.

  c. The responsibilities of management and employees who oversee the policies and procedures.

  d. Evidence that supports that the policies and procedures exist.

  e. Evidence that policies and procedures have been in place for a sufficient period.

  f. The distribution systems, products, and markets to which the policies and procedures apply.

  g. How the policies and procedures respond to the selected indicator.

Deployment

B.5. The two components underlying the second aspect, *deployment*, as defined by the Handbook are as follows:

a. Are the policies and procedures communicated?

b. Does the insurer consistently use these policies and procedures?

B.6. The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *deployment* aspect:

Examine/Inspect Documentation

- Obtain and read internal documents—including memos, email, handbooks, policy manuals, and contracts—to verify that communications have been made.
- Obtain and read written confirmation or other evidence that the intended audience of the policies and procedures has received and read the communication.

- Obtain independent confirmation that policies and procedures are being used.

Observation

- Observe that reference materials (internal or external) that may be required for personnel to adequately perform the policies and procedures are reasonably accessible.
- For a sample of items, perform a walkthrough of the policies and procedures deemed to be in place in the *approach* aspect to support that those policies and procedures are being consistently applied for distribution channels and product lines that use those policies and procedures. Determine that the policies and procedures have also been consistently applied for a sufficient time by including transactions for various dates in the sample of transactions for the walkthrough.

Inquiry

- Interview personnel who perform the activities described in the policies and procedures documents to support that policies and procedures have been communicated to them.

Monitoring

B.7. The two components underlying the third aspect, *monitoring*, as defined by the Handbook are as follows:

a. Does the insurer routinely monitor the operation of these policies and procedures with a view toward achieving the intended result?

b. Does the insurer act upon the information received?

B.8. The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *monitoring* aspect:

Examine Documentation

- Obtain and examine documents prepared by entity personnel that provide the responsible party with appropriate monitoring tools (for example, management reports, trend analyses, and tracking logs).
- Examine monitoring tools to identify deviations from the expected results, provide analysis of these deviations, and demonstrate investigation has occurred.
- Examine documentation of the corrective actions taken in response to information received by the responsible parties.
- Examine monitoring documents subsequent to corrective action taking place to ascertain whether the incidence of an identified problem or complaint has decreased in frequency because of the corrective action.

Inquiry

- Interview the personnel responsible for preparing reports used as monitoring tools to determine that the appropriate information is being gathered in a reasonable manner.
- Interview the personnel responsible for acting on the information provided and identify the procedures in place to perform corrective actions.

Observation

- Examine monitoring reports to ascertain whether they are prepared and distributed on a regular basis to the responsible personnel.
- Perform a walkthrough for a selection of transactions in which the action described by the identified responsible party should have occurred and ascertain whether the procedure was put in place.
- Observe changes in policies and procedures or communications to entity personnel that have occurred because of the recurrence of an identified problem or complaint.

APPENDIX C

Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this type of engagement.

[*CPA Firm Letterhead*]

[*Client's Name and Address*]

Dear ____________:

This will confirm our understanding of the arrangements for our examination of management's assertion that the affirmative responses of [*name of client entity*] to the Insurance Marketplace Standards Association ("IMSA") questionnaire (the "Questionnaire") relating to the Principles of Ethical Market Conduct and the Code of Ethical Market Conduct and Accompanying Comments for individually sold life and annuity products, are based on policies and procedures in place as of [*the IMSA report date*].

We will examine management's assertion that the affirmative responses to the Questionnaire are based on policies and procedures in place as of the IMSA report date for the purpose of expressing an opinion as to whether management's assertion is fairly stated, in all material respects, based upon the criteria set forth in the Principles of Ethical Market Conduct, Code of Ethical Market Conduct and Accompanying Comments, and Assessment Handbook. The Company is responsible for the design, implementation, and monitoring of the policies and procedures in place upon which the responses are based. Our responsibility is to express an opinion on management's assertion based on our examination.

We will conduct our examination in accordance with standards established by the American Institute of Certified Public Accountants and in accordance with the criteria set forth in the IMSA Assessment Handbook. Our examination will include obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based and such other procedures as we consider necessary in the circumstances. Our examination will not be designed to evaluate whether the policies and procedures, upon which [*the entity's*] responses to the Questionnaire are based, operate effectively, nor will we evaluate whether [*the entity*] has complied with applicable laws or regulations. Accordingly, we will not express an opinion or any other form of assurance thereon.[2]

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report.

At the completion of our work we expect to issue an examination report in a form acceptable to IMSA (example attached). If, however, we are not able to conclude that management's assertion that the affirmative responses to the Questionnaire are based on policies and procedures in place as of the IMSA report date, we will so advise you. At that time we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If no report is requested, we understand that our engagement will be terminated, our working papers will be destroyed (at your request), our professional fees will be payable in full, and

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[2] The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter.

our professional responsibilities to you will be complete. We will have no responsibility to report in writing at a later date. If you request written or oral communication of our findings, we will do so and our working papers will be retained in accordance with our firm's working paper retention policy. Our professional fees will be subject to adjustment. If you request that we delay issuance of our report until corrective action is taken that will result in affirmative answers to all questions, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy. Again, our fees will be subject to adjustment. If we conclude that we are unable to issue an unqualified report, we reserve the right to bring the matter to the attention of an appropriate level of management or the board of directors.

The distribution of the independent accountant's report will be restricted to the board of directors and management of [*the entity*] and IMSA. [*The entity*] agrees that it will not use the CPA firm's name in advertising materials referring to [*the entity's*] membership in IMSA.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us.

We appreciate the opportunity to serve you.

Sincerely,

____

[*Partner's Signature*]
[*Firm Name or Firm Representative*]

Accepted and agreed to:

____

[*Client Representative's Signature*]

____

[*Title*]

____

[*Date*]

Appendix T

Statement of Position 98-7

Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk

October 19, 1998

Issued by the
Accounting Standards Executive Committee

NOTICE TO READERS

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the area of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles *in the Independent Auditor's Report*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by this Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

TABLE OF CONTENTS

SUMMARY

This Statement of Position (SOP) provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in this SOP as deposit accounting. The SOP does not address when deposit accounting should be applied.

This SOP specifies the following.

- Insurance and reinsurance contracts for which the deposit method is appropriate should be classified as one of the following, which are those that—
  - Transfer only significant timing risk.
  - Transfer only significant underwriting risk.
  - Transfer neither significant timing nor underwriting risk.
  - Have an indeterminate risk.
- At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.
- Insurance and reinsurance contracts that transfer neither significant timing nor underwriting risk, and insurance and reinsurance contracts that transfer only significant timing risk, should be accounted for using the interest method. Changes in estimates of the timing or amounts of recoveries should be accounted for by recalculating the effective yield. The asset or liability should then be adjusted to the amount that would have existed had the new effective yield been applied since the inception of the contract. The revenue and expense recorded for such contracts shall be included in interest income or interest expense.
- Insurance or reinsurance contracts that transfer only significant underwriting risk should be accounted for by measuring the deposit based on the unexpired portion of the coverage provided until losses are incurred that will be reimbursed under the contracts. Once a loss is incurred that will be reimbursed under this kind of contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract, plus the remaining unexpired portion of the coverage provided. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, should be included in the income statement of the insured as an offset against the loss recorded by the insured that will be reimbursed under the contract and in an insurer's income statement as an incurred loss. The reduction in the deposit related to the unexpired portion of the coverage provided should be recorded by the insured and the insurer who are insurance enterprises as an adjustment to incurred losses. If the insured is an enterprise other than an insurance enterprise, then the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

- For insurance and reinsurance contracts with indeterminate risk, the guidance in SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance* as to the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. When sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the other three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly.

This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Restatement of previously issued annual financial statements is not permitted. Initial application of this SOP is as of the beginning of an entity's fiscal year (that is, if the SOP were adopted before the effective date and during an interim period, all prior interim periods are required to be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle, in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in their review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk

Introduction

1. "Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period. In exchange for a payment from the policyholder (a premium), an insurance enterprise agrees to pay the policyholder if specified events occur or are discovered. Similarly, the insurance enterprise may obtain indemnification against claims associated with contracts it has written by entering into a reinsurance contract with another enterprise."[1] Insurance and reinsurance contracts may be structured in various ways. The premium paid by the policyholder may represent a payment for the transfer of **insurance risk** or it may represent a deposit.[2]

2. Paragraph 44 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, states the following, in part.

> To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company.

3. FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* established certain conditions for determining whether a reinsurance contract indemnifies against loss or liability relating to insurance risk. Although existing accounting literature does not provide similar criteria to evaluate whether an insurance contract indemnifies against loss or liability, generally accepted accounting principles (GAAP) require a determination of whether insurance risk has been transferred (as discussed in paragraph 2 above). This SOP neither addresses *when* deposit accounting should be applied nor provides criteria to make this determination. Such guidance is provided on a case-by-case basis in the applicable pronouncements.

4. As stated above, FASB Statement Nos. 5 and 113 and Emerging Issues Task Force (EITF) Issue Nos. 93-14, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*, and 93-6, *Accounting for Multiple-Year Retrospectively Rated Reinsurance Contracts by Ceding and Assuming Enterprises*, each require that the deposit method of accounting be applied when parties enter into insurance or reinsurance contracts that do not transfer insurance risk. Nevertheless, the existing accounting pronouncements do not describe what is meant by deposit accounting in those circumstances or how it should be applied.

5. The consensus decisions in FASB EITF Issue Nos. 93-14 and 93-6 provide further guidance on when deposit accounting should be applied to reinsurance and insurance contracts.

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[1] The source is paragraph 1 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*

[2] Terms defined in the Glossary are set in boldface the first time they appear in this SOP.

Applicability and Scope

6. This SOP provides guidance on how to apply the deposit method of accounting when it is required for insurance and reinsurance contracts that do not transfer insurance risk. These contracts may be prospective or retroactive in nature. This SOP applies to all entities that have entered into the following kinds of insurance and reinsurance contracts:

a. Short-duration insurance and reinsurance contracts that do not transfer insurance risk as described in paragraph 44 of FASB Statement No. 5 and, for reinsurance contracts, as described in paragraphs 8 through 11 and 18(a) of FASB Statement No. 113 and EITF Issue No. 93-6.

b. Multiple-year insurance and reinsurance contracts that do not transfer insurance risk or for which insurance risk transfer is not determinable. (EITF Issue Nos. 93-14 and 93-6 prescribe the deposit method of accounting for multiple-year retrospectively rated insurance and reinsurance contracts, respectively, that do not transfer insurance risk.)

However, FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and FASB Statement No. 113 explicitly provide that long-duration life and health insurance contracts that do not indemnify against mortality or morbidity risk should be accounted for as investment contracts as defined and described in FASB Statement No. 97. Therefore, such contracts are not covered by this SOP.

7. This SOP does not address or change existing requirements as to when deposit accounting should be applied. Appendix A, "Illustrations of Application of Conclusions," herein, provides examples that illustrate the application of certain provisions of this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. The conclusions in this SOP apply to both the insured and the insurer in an insurance contract. The conclusions in this SOP also apply to the **ceding** and **assuming entity** in a reinsurance contract.

Kinds of Contracts

8. The transfer of insurance risk requires transferring both **timing risk** and **underwriting risk**. Therefore, four possible categories for deposit arrangements have been identified as follows.

a. *An insurance or reinsurance contract that transfers only significant timing risk.* For an insurance or reinsurance contract to be considered to have transferred significant timing risk, the timing of the loss reimbursement under the contract must be based on the timing of the loss event.[3] An insurance or reinsurance contract that transfers only significant timing risk limits the amount of underwriting risk to which the insurer or reinsurer is subject and is commonly entered into by the insured or ceding entity to provide liquidity. These limita-

[3] With respect to insurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of the payment with respect to the loss event. For reinsurance contracts, the timing of the loss reimbursement under the contract would be based on the timing of payment by the insured (reinsured) of the underlying loss, as well as when recovery is expected from the reinsurer.

tions may result in an insufficient transfer of insurance risk. For example, insurance and reinsurance contracts that provide for **experience adjustments** may indicate that a sufficient amount of underwriting risk has not been transferred. The recovery of the amount of the initial deposit for a contract that transfers only significant timing risk is not substantially dependent on future loss experience of the insured.

b. *An insurance or reinsurance contract that transfers only significant underwriting risk.* For an insurance or reinsurance contract to be considered to have transferred significant underwriting risk, the probability of a significant variation in the amount of payments under the insurance or reinsurance contract must be more than remote. Such variation must also result from variation in the insured's losses, and it must be at least reasonably possible that the insurer will realize a significant loss from the transaction. An insurance or reinsurance contract that transfers only significant underwriting risk may be entered into to lessen the overall economic risks associated with the contract and permit a greater amount of coverage than would otherwise be obtainable for a comparable premium. Features in insurance or reinsurance contracts that transfer only significant underwriting risk limit the uncertainties about the timing of the receipt and payment of cash flow, thus, limiting the amount of timing risk assumed by the insurer. A delayed reimbursement of losses by the insurer is a possible indication that timing risk has not been transferred.[4] Unlike insurance and reinsurance contracts that transfer only significant timing risk, the recovery of the amount of the initial deposit for an insurance or reinsurance contract that transfers only significant underwriting risk is substantially dependent on the future loss experience of the insured. Depending on such experience, the initial deposit may be recovered or the recovery may be significantly more or less than the original deposit.

c. *An insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk.* Insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are expected to be rare.

d. *An insurance or reinsurance contract with an indeterminate risk.* These insurance and reinsurance contracts have uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. For example, certain insurance and reinsurance contracts allow the insured to obtain some degree of coverage for multiple years without exposing the insurer to a defined level of insurance risk each year. Uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5.

For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk

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[4] FASB Statement No. 113, paragraph 9, states, in part, "A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Contractual provisions that delay timely reimbursement to the ceding enterprise would prevent this condition from being met."

to the reinsurer. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. If a short-duration reinsurance contract does not meet the second condition but transfers significant insurance risk, then the accounting for contracts that transfer only significant underwriting risk should be followed (see paragraphs 13 through 15 in this SOP).

Conclusions

Initial Measurement

9. At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. Deposit assets and liabilities should be reported on a gross basis, unless the right of offset exists as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*. The accounting by the insured and insurer are symmetrical, except as noted in paragraph 15 of this SOP.

Subsequent Measurement

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Underwriting Risk

10. For insurance and reinsurance contracts that transfer only significant timing risk or that transfer neither significant timing nor significant underwriting risk, the amount of the deposit asset or liability should be adjusted at subsequent reporting dates by calculating the effective yield on the deposit to reflect actual payments to date and expected future payments (as discussed in paragraph 11 below), with a corresponding credit or charge to interest income or expense. This approach is consistent with the interest method described in Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, and FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

11. The calculation of the effective yield should use the estimated amount and timing of cash flows. Consistent with paragraph 19 of FASB Statement No. 91, if a change in the actual or estimated timing or amount of cash flows occurs, the effective yield should be recalculated to reflect the revised actual or estimated cash flows. The deposit should be adjusted to the amount that would have existed at the balance-sheet date had the new effective yield been applied since the inception of the insurance or reinsurance contract. Changes in the carrying amount of the deposit should be reported as interest income or interest expense.

12. Significant changes in the expected amounts of aggregate cash flows are expected to occur infrequently because of the nature of these kinds of contracts. Should a significant change occur in the total amount of actual or estimated cash flows, the enterprise should determine whether the change indicates that the contract does include significant underwriting risk and therefore should be converted to the accounting for contracts that transfer only significant underwriting risk. (See paragraphs 13 through 15 for the accounting guidance for insurance and reinsurance contracts that transfer only significant underwriting risk.) In addition, a contract that transfers only significant timing risk, which subsequently is determined also to transfer significant underwriting risk, cannot be accounted for under insurance or reinsurance accounting when the revised determination is made.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

13. Until such time as a loss is incurred that will be reimbursed under an insurance or reinsurance contract that transfers only significant underwriting risk, the deposit should be measured based on the unexpired portion of the coverage provided. Once a loss is incurred that will be reimbursed under such a contract, then the deposit should be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided.

14. Changes in the recorded amount of the deposit, other than the unexpired portion of the coverage provided, arising from an insurance or reinsurance contract that transfers only significant underwriting risk should be recorded in an insured's income statement as an offset against the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract and in an insurer's income statement as an incurred loss. Insurance enterprises should record the reduction in the deposit related to the unexpired portion of the coverage provided as an adjustment to incurred losses. Insurance enterprises should disclose the amounts related to those deposit contracts that are reported in incurred losses in their statement of earnings. (See paragraph 19.) If the insured is an enterprise other than an insurance enterprise, the reduction in the deposit related to the unexpired portion of the coverage provided should be recorded as an expense.

15. For the insured or ceding enterprise, the discount rate used to determine the deposit asset should be the current rate on United States government obligations with similar cash-flow characteristics, adjusted for default risk. Consideration of the default risk, if any, should be based on the assessment of the creditworthiness of the insurer. For the insurer or assuming enterprise, the discount rate used to determine the deposit liability should be the current rate on United States government obligations with similar cash-flow characteristics. These rates should be established at the date of each loss incurred and used for the remaining life of the contract and should not be changed. If numerous losses occur, the use of average rates is permitted because establishing individual rates might require detailed recordkeeping and computations that could be burdensome and unnecessary to produce reasonable approximations of the results.

Insurance and Reinsurance Contracts With Indeterminate Risk

16. Uncertainties surrounding insurance and reinsurance contracts with indeterminate risk are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5. As a result, the guidance in SOP 92-5, regarding the open-year method, should be followed. The open-year method should not, however, be used to defer losses that otherwise would be recognized pursuant to FASB Statement No. 5.

17. Under the open-year method, the effects of the contracts are not included in the determination of net income until sufficient information becomes available to reasonably estimate and allocate premiums. The open-year method requires that these effects be aggregated in the balance sheet. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of the three categories as an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. The change in deposit assets or liabilities that result if sufficient information becomes available is treated as a change in accounting estimate in accordance with APB Opinion 20, *Accounting Changes.*

Disclosures

18. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.

19. Insurance enterprises should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:

a. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses

b. Any adjustment of amounts initially recognized for expected recoveries (The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.)

c. The amortization expense attributable to the expiration of coverage provided under the contract

Effective Date and Transition

20. This SOP is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Previously issued annual financial statements should not be restated. The initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, if the SOP is adopted prior to the effective date and during an interim period, all prior interim periods should be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

21. Because of questions raised about the application of the deposit method of accounting to insurance and reinsurance contracts that do not indemnify against loss or liability and the scarcity of guidance concerning the accounting for such contracts, AcSEC believes that guidance is needed for all entities that enter into insurance and reinsurance contracts that are to be accounted for as deposits under FASB Statement Nos. 5, 60, and 113 and EITF Issue Nos. 93-6 and 93-14. Long-duration life and health insurance and reinsurance contracts that do not indemnify against mortality and morbidity risk are not covered under this SOP because FASB Statement Nos. 97 and 113 provide sufficient guidance on accounting for these kinds of insurance and reinsurance contracts.

22. Paragraph 44 of FASB Statement No. 5 states the following.

> To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as such.[5]

That guidance also is incorporated in paragraph 18(a) of FASB Statement No.113.

23. The consensus in EITF Issue No. 93-6 states, the following, in part.

> The Task Force reached a consensus that in order to be accounted for as reinsurance, a contract that reinsures risk arising from short-duration insurance contracts must meet all of the following conditions: (1) the contract must qualify as a short-duration contract under paragraph 7(a) of Statement 60, (2) the contract must not contain features that prevent the risk transfer criteria in paragraphs 8 through 13 of Statement 113 from being reasonably applied (and those criteria must be met), and (3) the ultimate premium expected to be paid or received under the contract must be reasonably estimable and allocable in proportion to the reinsurance protection provided as required by paragraph 14(a) and (b) of Statement 60 and paragraph 21 of Statement 113. If any of these conditions are not met, a deposit method of accounting should be applied by the ceding and assuming enterprises.

The consensus in EITF No. 93-14 states, the following, in part.

> The Task Force reached a consensus that in order to be accounted for as insurance, an insurance contract must indemnify the insured as required by paragraph 44 of Statement 5. For those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured.

Initial Measurement

24. This SOP states that, at inception, insurance and reinsurance contracts accounted for under deposit accounting should be measured based on the consideration paid or received, less any explicitly identified premiums or fees

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[5] FASB Statement No. 113 amended FASB Statement No. 5 to include the following footnote at the end of paragraph 44: "Paragraphs 8 to 13 of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, identify conditions that are required for a reinsurance contract to indemnify the ceding enterprise against loss or liability and to be accounted for as reinsurance. Any transaction between enterprises to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, applies must meet those conditions to be accounted for as reinsurance."

to be retained by the insurer or reinsurer, irrespective of the experience of the contract. The provisions of paragraph 44 of FASB Statement No. 5 and paragraph 18a of FASB Statement No. 113 state that "for those contracts that do not provide indemnification, the premium paid, less the amount of the premium to be retained by the insurer, should be accounted for as a deposit by the insured." AcSEC believes that it may be difficult, if not impossible, to reasonably determine the amount of the premium to be retained by the insurer when initially measuring the deposit unless it is explicitly identified in the contract because the implicit rate of interest in the contract reflects a combination of considerations including prevailing market rates, uncertainty regarding amounts and timing of cash flows, as well as ranges of possible margins that may be retained by the insurer. The accounting provided in this SOP is similar to accounting for prepaid insurance.

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk and Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk

25. AcSEC concluded that the revenue and expense associated with insurance and reinsurance contracts that transfer only significant timing risk, and with insurance and reinsurance contracts that transfer neither significant timing nor significant underwriting risk are attributable primarily to the time value of money. Accordingly, AcSEC concluded that the interest method described in FASB Statement No. 91 is the appropriate model to apply to these kinds of insurance and reinsurance contracts. AcSEC also concluded that changes in actual or estimates of timing and, where applicable, the amount of cash flows under such insurance and reinsurance contracts should be accounted for consistent with paragraph 19 of FASB Statement No. 91 by recalculating the effective yield for the entire contract.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

26. This SOP requires that deposits under insurance and reinsurance contracts that transfer only significant underwriting risk be measured based on the unexpired portion of the coverage provided until such time as a loss is incurred that will be reimbursed under the contract. Once a loss is incurred that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk, the deposit is to be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the original deposit for the coverage provided.

27. AcSEC considered a variety of discount rates and concluded that the deposit should be measured by the present value of expected future cash flows discounted at the current risk-free rate available in the market, adjusted for default risk associated with the insurer's creditworthiness in the case of a deposit asset. AcSEC also discussed whether this rate should continue to be used in subsequent periods (often referred to as the *lock-in concept*) or whether the rate should change throughout the remaining life of the contract. AcSEC concluded that the rate should be established at the date of each loss incurred and used until the expected cash flows associated with the loss are collected. AcSEC believes that changes that occur are only changes in the estimate of cash flows and, therefore, the rate should not change. In those circumstances in which there is more than one loss, there will be different rates for each of the loss occurrences. If numerous losses occur, establishing these rates might require detailed recordkeeping and computations that could be burdensome as well as unnecessary to produce reasonable approximations of the results. Therefore, the use of average rates is permitted.

28. For insurance and reinsurance contracts that transfer insurance risk (meaning contracts that transfer both underwriting and timing risk), the purchaser (who is in a comparable position to the insured or ceding entity) pays a fixed or determinable amount and receives a right to an uncertain future return. Estimated recoveries under such contracts generally are recorded at undiscounted amounts. For insurance and reinsurance contracts that transfer only significant underwriting risk, the deposit is measured by the present value of the expected future cash flows. AcSEC believes that this difference in measurement—between insurance and reinsurance contracts that transfer insurance risk and those that transfer only significant underwriting risk—appropriately reflects the dissimilarities in these contracts, principally the failure of contracts that transfer only significant underwriting risk to match the timing of the recoveries to the timing of the payments of the loss.

29. When an asset or liability is measured by discounting expected future cash flows, the present value of such asset or liability will increase from one reporting period to the next as a result of the passage of time (assuming that the actual or expected timing and amount of cash flows remain constant). Nevertheless, the present value of a deposit under an insurance or reinsurance contract that transfers only significant underwriting risk may change from one reporting period to the next as a result of not only the passage of time but also the changes in actual or estimated timing and amount of cash flows.

30. AcSEC considered whether the change in the present value of the cash flows should be recognized entirely as interest related, entirely as underwriting related (offsetting the recorded loss under the insurance or reinsurance contract), or partly as interest related and partly underwriting related. AcSEC concluded that the entire change should be recognized in the income statement as an offset to the loss recorded by the insured that will be reimbursed under the insurance or reinsurance contract that transfers only significant underwriting risk. With regard to insurance enterprises and because of the significance of amounts recorded as incurred losses by these enterprises, AcSEC believes that disclosure of the components of the deposit that are recorded in incurred losses is appropriate. AcSEC noted that, if the *amount* of expected future cash flows under the deposit contract changes, the reporting entity will report both a change in the deposit and a corresponding change related to the underlying loss accrual; AcSEC concluded that both of those changes should be recognized in a similar manner. Additionally, because this kind of contract transfers significant underwriting risk, AcSEC considered it inappropriate to recognize the entire change in the present value of the cash flows as interest related. AcSEC also concluded that the costs of accounting separately for the interest-related component of the change in the present value of the cash flows outweighed the benefits of such separate accounting. AcSEC noted the following areas in which the interest-related component of a change in the present value of an asset or liability is recognized as an operating item rather than as interest related:

a. Accounting for long-duration insurance liabilities and changes in cash surrender value of life insurance contracts *b.* Accounting for pension and other post-retirement benefit expenses

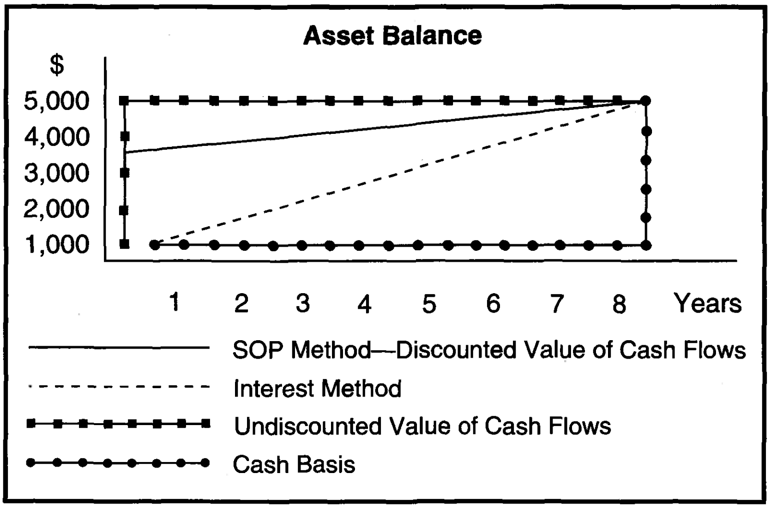
c. Accounting generally used when insurance claim liabilities are measured on a discounted basis

d. Accounting for a change in the present value of an impaired loan

31. AcSEC considered a variety of possible ways to apply deposit accounting to insurance and reinsurance contracts that transfer only significant underwriting risk. The following graph, which is based on the example in Appendix A, "Illustrations of Application of Conclusions," paragraphs A.6 through A.9, illustrates the effects of four alternative methods of accounting for insurance and reinsurance contracts that transfer only significant underwriting risk that were considered by AcSEC. In this example, the insured or ceding entity pays an initial premium of $1,000 and expects to recover $5,000 at the end of Year 8 based on an actual loss incurred by the insured. A delayed reimbursement clause mitigates timing risk.[6]

32. AcSEC eliminated from consideration the cash basis and the undiscounted value of cash flows methods because they fail to properly reflect the time value of money, the receivable or payable under the contract, or both.

33. AcSEC concluded that the interest method fails to recognize that the $5,000 incurred loss is a discrete event that has been recorded under the contract in Year 1 giving rise to the ultimate recovery of $5,000 in Year 8.



Insurance and Reinsurance Contracts With Indeterminate Risk

34. In insurance and reinsurance contracts with indeterminate risk, there are uncertain terms, or there is insufficient information to reasonably estimate and allocate premiums in proportion to the protection provided. Paragraph 15 of SOP 92-5 provides that, in circumstances in which a foreign ceding entity cannot provide the information required by the assuming entity to estimate both the ultimate premiums and the appropriate periods of recognition, the open-year method should be used.

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[6] The table only presents the recovery under the contract and does not depict the underlying loss associated with the contract.

35. AcSEC concluded that uncertainties surrounding these insurance and reinsurance contracts are analogous to those often associated with foreign property and liability reinsurance as addressed in SOP 92-5. As a result, the guidance in SOP 92-5 as to the open-year method should be followed.

36. If sufficient information becomes available to reasonably estimate and allocate premiums, the insurance or reinsurance contract with indeterminate risk should be reclassified into one of three categories as an insurance or reinsurance contract that transfers neither significant timing nor underwriting risk, transfers only significant timing risk, or transfers only significant underwriting risk, as appropriate, and accounted for accordingly. FASB Statement No. 113 provides that the determination of whether a contract transfers risk should be evaluated at the inception of the contract. There are no provisions in FASB Statement No. 113 that provide for subsequent reevaluation of a contract. Therefore, AcSEC concluded that when sufficient information becomes available to reasonably estimate and allocate premiums, the accounting for an insurance or reinsurance contract, with indeterminate risk at its inception, should be reclassified as an insurance or reinsurance contract that does one of the following:

1. Transfers neither significant timing nor significant underwriting risk
2. Transfers only significant timing risk
3. Transfers only significant underwriting risk

As appropriate, the reclassified contract should be accounted for accordingly using deposit accounting as described in this SOP.

APPENDIX A

Illustrations of Application of Conclusions

A.1. The following examples illustrate the application of the conclusions in this SOP. The illustrations are intended as examples only; it should not be construed that any aspect of the illustrations establishes or changes requirements as to when deposit accounting should be applied. Rather, the examples illustrate how deposit accounting is to be applied when it is determined that it should be applied under other accounting literature. These examples illustrate the accounting by the insured. The accounting by the insurer would be symmetrical, except as noted in paragraph 15 of this SOP.

Insurance and Reinsurance Contracts That Transfer Neither Significant Timing Nor Significant Underwriting Risk

A.2. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers neither significant timing nor significant underwriting risk. The facts are as shown in the following table.

Premium	$1,000
Coverage period	1 year
Expected recoveries	$250 at the end of each year for five years
Implicit interest rate	8 percent(*)

(*) Present value of $250 per year for five years at 8 percent = $1,000.

A.3. At contract inception, the insured records a $1,000 asset. Changes in the amount or timing of cash flows are not anticipated. As they are received, cash recoveries reduce the carrying amount of the deposit, and the carrying amount of the deposit is increased at each reporting date by the amount of the interest earned during the period. The example assumes that the enterprise is reporting related financial information as of the end of each year, as shown in the following table.

Description	*8-Percent Interest Income*	*Cash Recoveries*	*Deposit Balance*
Initial payment			$1,000
Year 1	$ 80		1,080
End of Year 1		$ (250)	830
Year 2	66		896
End of Year 2		(250)	646
Year 3	52		698
End of Year 3		(250)	448
Year 4	36		484
End of Year 4		(250)	234
Year 5	16		250
End of Year 5		(250)	0
Totals	$250	$(1,250)	$ 0

Insurance and Reinsurance Contracts That Transfer Only Significant Timing Risk

A.4. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant timing risk. The facts are as shown in the following table.

Premium	$1,000
Coverage period	1 year
Initial expected recoveries	$225 per year (at end of year) for five years
Initial implicit rate	4 percent(*)

(*) Present value of $225 per year for five years at 4 percent = $1,000.

This implicit rate often will be less than the current risk-free rate because of the uncertainties as to the timing of cash flows in the insurance or reinsurance contract.

A.5. At contract inception, the insured records a $1,000 asset. Though the total amount ($1,125) is likely to be paid, changes in estimates of the timing of cash flows are expected. At each subsequent reporting date, the amount of the deposit would be increased by the amount of interest earned during the period, calculated using the estimated future cash flows to determine the then-current implicit discount rate (this is consistent with the retrospective approach in applying the interest method). At the end of Year 2, the timing of anticipated recoveries under the insurance or reinsurance contract is revised. A reevaluation of the implicit interest rate produces a rate of 3.63 percent and an asset of $640 at the end of the year. Given the change in the expected timing of cash flows at the end of Year 2, the carrying amount of the asset would be calculated as shown in the following table.

Description	*Interest Income*	*Cash Recoveries*	*Deposit Balance*
Initial payment			$1,000
Year 1 (4 percent)(*)	$ 40		1,040
End of Year 1		$ (225)	815
Year 2 (4 percent)	33		848
End of Year 2		(200)	648
Yield adjustment	(8)		640
Year 3 (3.63 percent)	23		663
End of Year 3		(175)	488
Year 4 (3.63 percent)	18		506
End of Year 4		(175)	331
Year 5 (3.63 percent)	12		343
End of Year 5		(175)	168
Year 6 (3.63 percent)	7		175
End of Year 6		(175)	0
Totals	$125	$(1,125)	$ 0

(*) Implicit rate at the inception of the insurance or reinsurance contract.

Insurance and Reinsurance Contracts That Transfer Only Significant Underwriting Risk

A.6. This example illustrates the accounting by the insured for an insurance or reinsurance contract that transfers only significant underwriting risk. The facts are as shown in the following table.

Initial Premium	$1,000
Coverage period	1 year
Expected recoveries	Could aggregate up to $10,000 with none paid prior to Year 8 regardless of when the insured incurs or pays a loss

A.7. A delayed reimbursement clause, which provides that the full amount will be paid to the insured or ceding entity at the end of Year 8, mitigates timing risk. A $5,000 loss is incurred at the end of Year 1 and is expected to be recovered at the end of Year 8. The risk-free rate of interest in Year 1 for the period from the loss to the expected payment date, adjusted for default risk, is 6 percent. (For the insurer, the risk-free rate would be used but it would not be adjusted for default risk.) At the end of Year 3, the estimated loss is increased from $5,000 to $6,000.

A.8. At contract inception, the insured records a $1,000 asset. The $1,000 amount is amortized over the coverage period of one year. If the $5,000 loss is incurred, the insured increases the amount of the asset by the present value of the $5,000. (Note that the insured has recorded the entire $5,000 loss from the underlying event in the same period.) At each subsequent reporting date, the portion of the carrying amount of the asset attributable to the incurred loss would be recalculated by discounting the estimated future cash flows.

A.9. The carrying amount of the asset would be calculated as shown in the following table.

Description	*Amortization*	*Offset to Recorded Losses*	*Cash Recoveries at End of Year*	*Deposit Balance*
Initial payment				$1,000
Amortization	$1,000			0
Year 1		$3,325(*)		3,325(†)
Year 2		200		3,525
Year 3		211		3,736
Adjustment		**747**		4,483(‡)
Year 4		270		4,753
Year 5		284		5,037
Year 6		303		5,340
Year 7		320		5,660
Year 8		340	$6,000	0
Totals	$1,000	$6,000	$6,000	$ 0

(*) The loss occurred on the last day of the year.

(†) The present value of $5,000 received after seven years discounted at 6 percent. At the end of Year 1, there is no remaining deposit applicable to the unexpired portion of the coverage because it is a one-year contract.

(‡) The present value of $6,000 received after five years discounted at 6 percent.

Conversion From a Contract That Transfers Neither Significant Timing Risk Nor Significant Underwriting Risk or a Contract That Transfers Only Significant Timing Risk to a Contract That Transfers Significant Underwriting Risk

A.10. The following illustration builds on the examples in paragraphs A.4 and A.5. It uses the same assumptions and facts as that example for the first two years; however, at the end of Year 3, the estimated recovery is increased from $1,125 to $1,950 (with the remaining recovery to be $450 per year for the remaining three years). For purposes of this example, assume the magnitude of the change in the estimated recovery is such that a determination should be reached that the contract does include significant underwriting risk. The risk-free rate of interest at Year 1 is 6 percent adjusted for default risk. In addition, this rate would be utilized when appropriate for the life of the contract.

Description	*Interest Income*	*Offset to Recorded Losses*	*Cash Recoveries at End of Year*	*Deposit Balance*
Initial payment				$1,000
Year 1 (4 percent)	$40		$ (225)	815
Year 2 (4 percent)	25(*)		(200)	640
Year 3 (3.63 percent)	23		(175)	488
Adjustment		$715(†)		1,203(‡)
Year 4 (6 percent)		72	(450)	825
Year 5 (6 percent)		50	(450)	425
Year 6 (6 percent)		25	(450)	0
Totals	$88	$862	$(1,950)	$ 0

(*) The interest income adjustment at 4 percent of $33 less the yield adjustment of $8 equals $25.

(†) At the end of Year 3, there is a change in the estimated recovery to $1950. The payment of the remaining losses will occur over three years, in Years 4, 5, and 6.

(‡) The present value of $450 per year for three years discounted at 6 percent (the risk-free rate at the time of the loss adjusted for default risk).

APPENDIX B

Discussion of Comments Received on the Exposure Draft

B.1. An exposure draft of a proposed Statement of Position, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, was issued for public comment on June 30, 1997, and distributed to a variety of interested parties to encourage comment by those who would be affected by the proposal. Twenty-three comment letters were received in response on the exposure draft. The most significant and pervasive comments received were in the following areas:

a. Scope

b. Kinds of contracts

c. Risk transfer criteria for direct insurance contracts

d. Recognition of fees to be retained by the insurer or reinsurer

e. Discount rate

f. Accounting for contracts that transfer only significant underwriting risk

Scope

B.2. The guidance regarding scope in the exposure draft caused some confusion. Several respondents requested clarification about the kinds of insurance contracts that would be covered by the SOP. AcSEC clarified the guidance to explain that the SOP applies to contracts that do not transfer insurance risk, except for those contracts which Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards Nos. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* and 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, provide explicit guidance.

Kinds of Contracts

B.3. Several comment letters expressed concern about the complexity of the various contract types. AcSEC continues to believe that the various deposit categories are appropriate and adequately capture the majority of potential kinds of contracts.

B.4. For short-duration reinsurance contracts, FASB Statement No. 113 requires that two conditions be met in order to account for that contract as reinsurance. The first condition is that the contract must transfer significant insurance risk to the reinsurer. The SOP provides guidance on accounting for contracts that fail to transfer one or both of these risks, which must be transferred for a contract to be considered to have transferred significant insurance risk. FASB Statement No. 113 also provides a second condition that must be met for a contract to receive reinsurance accounting. The second condition is that the contract must subject the reinsurer to the reasonable possibility of realizing a significant loss from the transaction, unless substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. The exposure draft did not specifically identify this situation. The SOP has been changed to state that for short-duration reinsurance contracts that do not meet the second condition, but that do transfer significant insurance risk, the accounting for these reinsurance contracts should be the same as the accounting for contracts that transfer only significant underwriting risk. AcSEC believes that for short-duration reinsurance contracts to satisfy the requirements of paragraph 9a of FASB Statement No. 113, there is an expectation that there is variability in the amount and timing of expected cash flows. Therefore, the accounting for contracts that transfer only significant underwriting risk would be appropriate.

Risk Transfer Criteria for Direct Insurance Contracts

B.5. Several comment letters expressed concern that the risk transfer criteria from FASB Statement No. 113 were being applied to direct insurance contracts. Paragraph 44 of FASB Statement No. 5, *Accounting for Contingencies*, and FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, do not specifically state risk transfer criteria in the same manner as does FASB Statement No. 113. The SOP's objective is to address how to account for contracts that do not transfer insurance risk and consequently must be accounted for as deposit accounting. The SOP is not intended to provide a method to determine whether risk transfer exists.

Recognition of Fees to Be Retained by the Insurer or Reinsurer

B.6. Several comments were received on the initial measurement of the deposit asset or liability relating to the recognition of fees to be retained by the insurer or reinsurer. AcSEC continues to believe that such fees should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, based upon the terms and conditions of the contract. AcSEC believes that a reasonable determination of premiums or fees is ordinarily not possible at the inception of the contract. Each contract should be evaluated based on its relevant terms and conditions.

Discount Rate

B.7. The use of a risk-free interest rate locked in at the loss event was addressed in several comment letters. Several respondents believe that this method is inconsistent with other accounting literature and believe the rate does not fully recognize the current market value of the deposit. AcSEC believes that the method chosen is consistent with other recent literature issued. The SOP has been changed to explicitly document that AcSEC believes that changes that occur are only changes in the estimate of expected cash flows resulting from the previous loss event and, therefore, the rate should not change. It is not AcSEC's intention to measure the deposit amount on a fair-value basis.

Accounting for Contracts That Transfer Only Significant Underwriting Risk

B.8. The accounting in the SOP prescribes that recoveries for contracts that transfer only significant underwriting risk to be recognized through underwriting income. Some respondents believe that the accounting is inconsistent with FASB Statement No. 113. Other respondents believe that these kinds of contracts should receive reinsurance accounting under FASB Statement No. 113 when a recovery under the contract occurs. Some changes in the balance of the amount recoverable are related to underwriting activities and it is, therefore, reasonable to include that activity in the underwriting account. AcSEC believes that bifurcation or a financial approach that would allocate underwriting and interest components would be preferable; however, current insurance company GAAP does not permit that approach. Therefore, AcSEC continues to believe that the accounting described in the SOP is appropriate.

Glossary

Assuming entity (or enterprise). The party that receives a reinsurance premium in a reinsurance transaction. The assuming enterprise (or reinsurer) accepts an obligation to reimburse a ceding enterprise under the terms of the reinsurance contract.

Ceding entity (or enterprise). The party that pays a reinsurance premium in a reinsurance transaction. The ceding enterprise receives the right to reimbursement from the assuming enterprise under the terms of the reinsurance contract.

Experience adjustment. A provision in an insurance or reinsurance contract that modifies the premium, coverage, commission, or a combination of the three, in whole or in part, based on experience under the contract.

Insurance risk. The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

Timing risk. The risk arising from uncertainties about the timing of the receipt and payments of the net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Underwriting risk. The risk arising from uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract.

Appendix U

Statement of Position 00-3

Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts

December 15, 2000

Issued by the
Accounting Standards Executive Committee

NOTICE TO READERS

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the area of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

TABLE OF CONTENTS

SUMMARY

This Statement of Position (SOP) provides guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding companies (MIHC). The SOP also applies to stock insurance enterprises that apply SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, to account for participating policies that meet the criteria of paragraph 5 of SOP 95-1.

The SOP specifies the following:

- *Financial statement presentation of the closed block.* Closed block assets, liabilities, revenues, and expenses should be displayed together with all other assets, liabilities, revenues, and expenses of the insurance enterprise based on the nature of the particular item, with appropriate disclosures relating to the closed block.
- *Accounting for predemutualization participating contracts after the demutualization date or formation of an MIHC and for stock insurance enterprises that have adopted SOP 95-1.* A demutualized insurance enterprise should continue to apply the guidance of SOP 95-1 to its participating contracts issued before the date of demutualization or formation of the MIHC that are within the scope of SOP 95-1. However, the segregation of undistributed accumulated earnings on participating contracts is meaningful in a stock life insurance company, because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, after the date of demutualization or formation of an MIHC, the provisions of paragraphs 41 and 42 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 60, *Accounting and Reporting by Insurance Enterprises*, relating to dividends on participating contracts should apply to such contracts sold before the date of demutualization or formation of the MIHC.
- *Emergence of earnings.* Cumulative actual closed block earnings in excess of the expected periodic amounts calculated at the date of demutualization or formation of an MIHC or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this SOP, that will not inure to the stockholders should be recorded as an additional liability to closed block policyholders (referred to as a policyholder dividend obligation).
- *Accounting for participating policies sold outside the closed block after the date of demutualization or formation of an MIHC.* SOP 95-1 should be applied to participating policies that meet its conditions and are sold outside the closed block after the date of demutualization or formation of the MIHC. However, provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to such contracts sold after the date of demutualization or formation of an MIHC.
- *Accounting for expenses related to a demutualization and the formation of an MIHC.* Direct incremental costs related to a demutualization or formation of an MIHC should be classified as a single line item within income from continuing operations.
- *Accounting for retained earnings and other comprehensive income at the date of demutualization and formation of an MIHC.* An insurance enterprise that demutualizes in a distribution-form demutualization

should reclassify all its retained earnings as of the demutualization date to capital stock and additional paid-in capital accounts (the capital accounts). A subscription-form demutualization does not by itself result in reclassification of retained earnings. The equity accounts of an MIHC at the date of formation should be determined using the principles for transactions of companies under common control, with the amount of retained earnings of the demutualized insurance enterprise, before reclassification to the capital accounts, being reported as retained earnings of the MIHC. Because the accounting bases and carrying amounts of assets and liabilities are not changed as a consequence of demutualization or formation of an MIHC, the amounts in accumulated other comprehensive income should also not be changed as a consequence of demutualization or formation of an MIHC.

- *Accounting for a distribution from an MIHC to its members.* Because the members of an MIHC are also policyholders of the stock insurance subsidiary, a distribution by an MIHC to its members should be accounted for according to the substance of the transaction. Unless there are substantive independent third-party stockholders, the distribution should be accounted for as a policyholder dividend.

This SOP applies to past and future demutualizations or formations of an MIHC. For those that occur after December 31, 2000, this SOP is effective on the date of the demutualization or formation of the MIHC. For a demutualization or formation of an MIHC that occurred on or before December 31, 2000, this SOP, with the exception of paragraph 18, should be applied retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. A stock insurance enterprise that has elected to adopt SOP 95-1 and that did not convert from a mutual life insurance enterprise should apply the provisions of paragraph 17 of this SOP retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. Paragraph 18 of this SOP is effective upon issuance with restatement required for those expenses presented in financial statements for any period presented for comparative purposes. Early adoption of this SOP is encouraged.

The beginning balance of retained earnings and, if necessary, any other components of stockholders' equity, for the earliest year presented should be adjusted for the effect of restatement or reclassification as of the earliest year restated. In the year this SOP is first applied, the financial statements should disclose the effect on income before extraordinary items, net income, and related per share amounts for each year restated or reclassifed. If the actuarial calculation is prepared as of the beginning of the year of adoption of this SOP, its implementation will not result in restatement to recognize a policyholder dividend obligation. Pro forma information for years prior to a demutualization or formation of an MIHC is not required.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts

Introduction and Background

1. Mutual insurance enterprises differ from stock insurance enterprises in that they do not have stockholders. The enterprise is considered to be owned by policyholders whose insurance contracts embody their rights as insureds and as members of the mutual insurance enterprise. Many mutual insurance enterprises are seeking enhanced financial flexibility and better access to capital markets to support long-term growth and to accomplish strategic initiatives. In light of those economic factors as well as increased competition and regulatory considerations, there has been a recent trend for certain mutual insurance companies to demutualize or to form mutual insurance holding companies (MIHC). The process of **demutualization**[1] or formation of an MIHC is subject to scrutiny and approval by state insurance regulatory authorities. Most states have some form of demutualization statute. A range of demutualization statutes and regulations exist for insurance enterprises. Typically, those laws contemplate a direct and full reorganization of the mutual insurer to a stock form. In accordance with some demutualization statutes, eligible policyholders receive stock, **policy credits**, policyholder benefits, cash, or subscription rights as consideration for their membership interest. This Statement of Position (SOP) uses the term *distribution-form demutualization* to refer to situations in which eligible policyholders receive stock, policy credits, additional policyholder benefits, cash or rights to purchase stock at favorable terms. This SOP uses the term *subscription-form demutualization* to refer to situations in which eligible policyholders receive only the right to purchase stock in the insurance enterprise or its parent at terms essentially equivalent to the terms offered to independent third parties.

2. The process for allocating the aggregate consideration among eligible policyholders varies based on individual company circumstances and applicable regulatory statutes. The allocation process generally consists of a fixed and a variable component. The fixed component represents consideration for eligible policyholders' membership interest in the mutual insurer and consists of a given number of shares per policyholder (or sometimes, per policy). The variable component represents consideration for eligible policyholders' contribution to the value of the insurer. The variable component of the aggregate compensation is allocated to policyholders in proportion to the actuarial contributions of their eligible policies, if positive. A policy's actuarial contribution consists of its historical equity share (the policy's past contribution to company equity) and, in most cases, the prospective equity share (the present value of the policy's expected future contributions to company equity).

3. An alternative to demutualization, in the jurisdictions where it is permitted, is for a mutual insurance enterprise to form an MIHC. The mutual

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[1] Terms defined in the glossary are in boldface type the first time they appear in this Statement of Position.

insurer is converted to a stock insurance enterprise and becomes a stockholder-owned entity that operates as a subsidiary of the newly formed MIHC. All the initial stock of the reorganized enterprise is issued to the MIHC; MIHC governance is established by the former mutual insurance enterprise's board of directors. The converted stock insurer may generate additional capital through an initial or subsequent public offering; however, most statutes specify that the MIHC must own greater than 50 percent of the voting rights of the converted insurer to ensure that the MIHC maintains effective control. The policyholders of the converted insurer become members of the MIHC through the transfer of their mutual membership interests to the MIHC, retaining the same voting rights they had previously. Policyholders with **participating insurance contracts** retain their participating contract in the converted stock insurer, but unlike in a demutualization, there is no distribution of equity or subscription rights to policyholders. A number of states have enacted or are currently contemplating enactment of MIHC statutes.

4. A demutualization or formation of an MIHC in and of itself does not constitute a change in ownership that requires a change in the historical accounting bases or **carrying amounts** of assets and liabilities. Paragraph 24 of Financial Accounting Standard Board (FASB) Technical Bulletin (TB) 85-5, *Issues Relating to Accounting for Business Combinations*, states in part, "In the special case of a mutual or cooperative enterprise that converts to stock ownership for purposes of effecting a business combination, the conversion is not a shift of equity ownership from one group of equity owners to another. It is a shift from a form of organization that has no substantive equity ownership to one that has." This SOP does not address what constitutes a change in ownership or reporting entity that would require a change in basis for the reported assets and liabilities.

5. Most of the past demutualizations and at least one of the past MIHC conversions have been accompanied or followed by an initial public offering of the stock of a demutualized insurance enterprise or an intermediate holding company of the MIHC. In connection with a demutualization or the formation of an MIHC, some state insurance departments require that a **closed block** or alternative mechanism be established for certain participating insurance policies to protect the adjustable policy features and dividend expectations of participating life insurance policyholders from the competing interests of stockholders. Typically, the **plan of demutualization** describes how the closed block will operate. The closed block assets and cash flows provided by those assets (see paragraph 8 of this SOP) will not inure to the stockholders of the demutualized company; instead, all cash flows from those assets will be used to benefit the closed block policyholders (absent regulatory approval to the contrary or insolvency of the insurer). Because the insurance enterprise remains obligated to provide for minimum guarantees under the participating policy, it is consequently possible under certain circumstances that funds from outside the closed block will have to be used to meet the contractual benefits of the closed block policyholders. The assets designated to the closed block are subject to the same liabilities, with the same priority in the case of insolvency or in liquidation, as assets outside the closed block. In many situations, commissions and other expenses (including management expenses) of operating and administering the closed block will not be charged to the closed block. Unless the state insurance department consents to an earlier termination, the closed block will continue in effect until the date on which none of the policies in the closed block remains in force.

6. Alternatives to the closed block have arisen in practice encompassing, for a number of types of contracts, various mechanisms believed by the insurance enterprise and state insurance regulators to be appropriate in the specific circumstances. Closed block alternative mechanisms have been used in lieu of closed blocks for certain participating life contracts to commit to the insurance regulator that the insurance company will continue to follow its established dividend practices. Closed block alternative mechanisms also have been used to protect nonguaranteed elements of participating and **nonparticipating insurance contracts** such as interest credits on deferred annuities and adjustable premiums on adjustable premium term business. In some instances, the methodology and limitations defined in the agreements with the state insurance regulators have considered only specific profit components, such as **mortality** experience on a block of term insurance or investment spreads on a block of annuities, and in other instances have considered virtually all components of product profitability. If there is a limitation on the profits that may inure to the stockholders, there is an agreement between the insurance company and the insurance regulators that defines (*a*) the contracts covered by the limitation, (*b*) the profit limitation calculation, and (*c*) the timing and manner (for example, as policy dividends, reduced premiums, or additional benefits) in which amounts that may not be distributed to stockholders are to be distributed to policyholders. The conclusions reached in this SOP apply to all formal closed blocks and to closed block alternative mechanisms to the extent the concepts are applicable to them, and are referred to as *closed block* in this SOP.

Operation of the Closed Block

7. The process of formation of the closed block is negotiated between the insurance company and the applicable state insurance regulators. Estimated future cash flows are considered in determining the nature and amount of assets designated to the closed block. The assets that are designated to the closed block are expected to produce cash flows sufficient to satisfy the obligations of the closed block, as well as the continuation of policyholder **dividend scales** and policy credits before the demutualization, if the underlying experience continues. Actual policy dividends paid may be increased or decreased based on the effect of future events, such as investment experience, mortality gains or losses, and **persistency** of the closed block policies. The assets designated to the closed block continue to be accounted for as they were before the date of demutualization.

8. The specific policyholder contracts designated for inclusion in the closed block are part of the negotiation process with the insurance regulators. The policyholder liabilities for those closed block participating policies continue to be calculated under the provisions of SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, and FASB Statement of Financial Accounting Standards Nos. 60, *Accounting and Reporting by Insurance Enterprises*, and 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as well as this SOP.

9. If cash flows from the closed block assets and experience of the closed block are, in the aggregate, more or less favorable than assumed in the funding of the closed block, total dividends paid to closed block policyholders could differ from the original dividend assumptions. Net favorable deviations in closed block performance, unless reversed by subsequent unfavorable experience, will be available for distribution over time only to closed block policyholders and will not be available to the insurance enterprise or its stockholders. Net unfavorable deviations could result in reduced dividends to closed block policyholders, unless reversed by future favorable experience or ultimately funded from assets outside of the closed block.

10. Regardless of the closed block's performance, the insurance enterprise is obligated to pay guaranteed benefits under the policies in accordance with their terms. If the cash flows from the assets allocated to the closed block and the policies included in the closed block prove to be insufficient to pay the benefits guaranteed under the policies included in the closed block, the insurance enterprise will be required to make those payments from assets outside of the closed block.

Applicability and Scope

11. This SOP is applicable to all insurance enterprises subject to FASB Statement No. 60 that demutualize or form an MIHC or have done so before the effective date of this SOP. However, if an insurance enterprise demutualized before the effective date of FASB Statement No. 120, *Accounting and Reporting by Mutual Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, this SOP does not require the insurance enterprise to apply SOP 95-1 unless it had previously elected to do so. For those stock insurance enterprises that apply the provisions of SOP 95-1, the provisions of paragraph 17 of this SOP apply.

Conclusions

Financial Statement Presentation of the Closed Block

12. Closed block assets, liabilities, revenues, and expenses should be displayed together with all other assets, liabilities, revenues, and expenses of the insurance enterprise based on the nature of the particular item, with appropriate disclosures relating to the closed block. (See paragraphs 24 and 25 of this SOP.)

Accounting for Predemutualization Participating Contracts After the Demutualization Date or Formation of an MIHC

13. The accounting guidance in SOP 95-1 is the appropriate accounting method for participating policies that meet the conditions of paragraph 5 of SOP 95-1 and, therefore, an insurance enterprise should continue to apply that guidance to demutualized insurance enterprises' participating contracts issued before the date of demutualization or formation of an MIHC. However, the segregation of undistributed accumulated earnings on participating contracts is meaningful in a stock life insurance company, because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, after the **date of demutualization** or formation of an MIHC, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to those contracts sold before the date of demutualization or formation of an MIHC.

Emergence of Earnings

14. The amounts to be included in net income relative to assets and liabilities included in the closed block are limited, based on a calculation prepared as of the date of demutualization or formation of an MIHC or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this SOP

(actuarial calculation date). As of the actuarial calculation date, the generally accepted accounting principles (GAAP) carrying amount of closed block liabilities will typically exceed the GAAP carrying amount of closed block assets. Certain of those assets, such as debt securities classified as available-for-sale under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, will be carried at fair value with unrealized holding gains and losses included in other comprehensive income until realized. A demutualization or formation of an MIHC does not, in and of itself, constitute a change in ownership that results in the realization of those unrealized gains and losses. Instead, those unrealized gains and losses will be realized over the period the closed block policies remain in force, as are all other transactions relating to the closed block assets and liabilities. As a result, the GAAP carrying amounts of the closed block assets must be adjusted to remove those unrealized amounts to determine the maximum future earnings (before items that may not have been considered in the funding of the closed block, such as commissions and maintenance expenses; see paragraph 6 of this SOP) that would be recognized in income over the period the policies in the closed block remain in force. For example, as part of the negotiations surrounding the closed block and demutualization process, the insurance enterprise may agree with the insurance regulator to designate participating policies with a GAAP carrying amount (liability) of $2,500,000,000 for the closed block. Fixed maturity available-for-sale investments with a carrying value and fair value of $2,300,000,000 and an amortized cost of $2,240,000,000 are designated as the closed block assets. If there are no other assets or liabilities included in the closed block, the maximum future earnings from the closed block that would be recognized in income over the period in which the closed block remains in force is $260,000,000.

15. The changes in the **net closed block liability** over time represents the expected closed block GAAP contribution to the earnings of the insurer that inure to the benefit of the stockholders. As of the actuarial calculation date, a calculation is developed that represents the cash flows expected to be generated from the assets and liabilities included in the closed block. Based on that calculation (the **actuarial calculation)**, the periodic expected changes in the net closed block liability (on a GAAP basis), which is after the elimination of the effect of the applicable items of other comprehensive income should be derived. The actuarial calculation should be based on a best estimate (with no provision for adverse deviation) of the future performance of the closed block assets and liabilities as of the actuarial calculation date. Cumulative actual closed block earnings in excess of the cumulative expected periodic amounts reflected in the actuarial calculation do not inure to the stockholders and should be recorded as an additional liability to closed block policyholders (referred to as a policyholder dividend obligation). Those amounts will result in additional future dividends to closed block policyholders unless otherwise offset by less-favorable-than-expected future performance of the closed block.

Determination of the Policyholder Dividend Obligation

16. The actuarial calculation described above should continue to be used in subsequent accounting periods to determine the change in the policyholder dividend obligation. The actuarial calculation should not be revised in future accounting periods. The amount of the policyholder dividend obligation should be determined by comparing cumulative actual earnings of the closed block from the actuarial calculation date to the date of measurement with the amount of cumulative expected earnings based on the actuarial calculation for the same period. Cumulative actual earnings in excess of cumulative expected earnings based on the actuarial calculation should be recorded as a policyholder dividend obligation. Unrealized investment gains and losses and other amounts related to the closed block normally reported in accumulated other comprehensive income that have arisen after the actuarial calculation date should be included in the determination of the amount of the policyholder dividend obligation limited, in the case of losses, to the extent that the policyholder dividend obligation is otherwise positive. Unrealized investment gains and losses and other items related to the closed block normally reported in accumulated other comprehensive income that have arisen at or after the actuarial calculation date should continue to be reported in accumulated other comprehensive income. Amounts related to the closed block that have arisen after the actuarial calculation date should enter into the determination of the policyholder dividend obligation with an offsetting amount reported in accumulated other comprehensive income. The amount charged to policyholder dividend obligation for losses should be limited to the extent that the policyholder dividend obligation is otherwise positive. Unrealized investment gains and losses, other items of accumulated other comprehensive income, and the amount of offsetting policyholder dividend obligation should not be netted in the presentation of other comprehensive income. Those amounts should be reported in the income statement and the amounts previously reported in other comprehensive income should be reversed when investment gains and losses and other items of other comprehensive income are realized. Unrealized investment losses and other loss items related to the closed block that would result in a negative policyholder dividend obligation should be recognized in other comprehensive income applicable to stockholders—the policyholder dividend obligation account may not have a negative balance. The policyholder dividend obligation will decrease if experience is less favorable than expected and the dividend scale is not commensurately reduced. If dividends paid are higher than originally expected in the dividend scale, the policyholder dividend obligation will decrease.

Accounting for Participating Policies Sold After the Date of Demutualization or Formation of an MIHC and for Stock Insurance Enterprises That Adopted SOP 95-1

17. The accounting guidance in SOP 95-1 should be applied to demutualized insurance enterprise participating contracts meeting the SOP's criteria issued after the date of demutualization or formation of an MIHC. The segregation of undistributed accumulated earnings on participating contracts in excess of amounts that inure to stockholders is meaningful in a stock life insurance company because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 relating to dividends on participating contracts should apply to contracts that are sold after the date of demutualization or formation of an MIHC and meet the requirements of SOP 95-1. Those provisions should also be applied by stock insurance enterprises that adopted SOP 95-1 with respect to participating contracts for which limitations exist on the amount of net income that may be distributed to stockholders. If there is a limitation on the amount of income from participating contracts issued after the date of demutualization or formation of an MIHC that may be distributed to stockholders, the policyholders' share of income on those contracts that may not be distributed to stockholders should be charged to operations with a corresponding credit to a liability. Dividends paid to participating policyholders reduce that liability.

Accounting for Demutualization and MIHC Expenses

18. In connection with a demutualization or formation of an MIHC, an insurance enterprise will incur expenses, including those for legal services, actuarial services, printing, and postage. Direct and incremental costs related to a demutualization or formation of an MIHC should be classified as a single line item within income from continuing operations and should not be classified as an extraordinary item.

Accounting for Retained Earnings and Accumulated Other Comprehensive Income at the Date of Demutualization or Formation of an MIHC

19. Depending on the form of demutualization, a reclassification of retained earnings at the date of demutualization may be appropriate. An insurance enterprise that demutualizes in a distribution-form demutualization should reclassify all its retained earnings as of the date of demutualization to capital stock and additional paid-in capital accounts (the capital accounts). If the enterprise distributes cash or policy credits to policyholders in lieu of capital stock, as part of the demutualization, the distribution should be recorded as a direct reduction to the appropriate capital accounts. A subscription-form demutualization does not, by itself, result in reclassification of retained earnings.

20. The equity accounts of an MIHC at the formation date should be determined using the principles for transactions of companies under common control, with the amount of retained earnings of the demutualized insurance enterprise, before reclassification to the capital accounts, being reported as retained earnings of the MIHC. Because the accounting bases and carrying amounts of assets and liabilities are not changed as a consequence of demutualization or formation of an MIHC, the amounts in accumulated other comprehensive income also should not be changed as a consequence of demutualization or formation of an MIHC.

Accounting for the Dividends From a Stock Insurance Subsidiary to an MIHC

21. A dividend payable to stockholders, whether declared by a stock insurer or its holding company, is a common corporate capital transaction. Cash dividends should be recorded on the books of the corporation as a liability on the declaration date. A stock dividend declared by the stock insurer should be accounted for in accordance with Accounting Research Bulletin (ARB) 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 7, "Capital Accounts," section B, Stock Dividends and Stock Split-ups. Under existing laws or regulations, an MIHC is required to own a controlling voting interest in the stock insurance subsidiary and, therefore, should reflect the stock insurer or intermediate holding company on a consolidated basis. As a result, intercompany dividends should be eliminated in the consolidated accounts of the MIHC.

Accounting for a Distribution From an MIHC to Its Members

22. Because the members of an MIHC are also policyholders of the stock insurance subsidiary, a distribution by an MIHC to its members should be accounted for according to the substance of the transaction. Unless there are substantive independent third-party stockholders of the demutualized insurance enterprise or intermediate holding company of the MIHC, the distribution should be accounted for as a policyholder dividend. If there are substantive independent third-party stockholders and the following conditions also are satisfied, the distribution is presumed to be appropriately accounted for as an equity dividend.

a. There is a mechanism to ensure that policyholder dividends are not a component of the MIHC distribution.

b. All MIHC members are eligible to receive the MIHC distribution and the allocation of MIHC distribution is consistent with the concept of MIHC membership (depending on the jurisdiction, it may be based on equity share or equally distributed to each MIHC member).

c. The distribution is legally characterized as a membership distribution rather than a policyholder distribution.

23. If a distribution by the MIHC is determined to be a policyholder dividend expense, the insurance subsidiary should reflect the policyholder dividend in its separate financial statements as an expense with recognition of a corresponding capital contribution from the MIHC. The MIHC should reflect the amount of the distribution as a capital contribution to the insurance subsidiary in its separate financial statements. In consolidated financial statements, the expense would be reported and the capital contribution would be eliminated.

Disclosures

24. An insurance enterprise should disclose the nature and terms of a demutualization or formation of an MIHC and the basis of presentation and terms of operation of the closed block. In addition, the insurance enterprise should provide a general description of the method of emergence of earnings from the closed block, presentation of assets and liabilities of the closed block, and the policyholder dividend obligation.

25. An insurance enterprise that has formed a closed block should disclose the following (refer to appendix A, "Illustrative Guidance—Footnote Disclosure for the Closed Block," for an illustrative example):

a. A general description of the closed block, including the purpose of the closed block, the types of insurance policies included, and the nature of the cash flows that increase and decrease the amount of closed block assets and liabilities. The description should indicate the continuing responsibility of the insurance enterprise to support the payment of contractual benefits and the nature of expenses charged to the closed block operations.

b. Summarized financial data of the closed block as of, or for periods ending on the date of, the financial statements presented, which should include, at a minimum, the carrying amounts for the major types of invested assets of the closed block, future policy benefits and policyholders' account balances, policyholder dividend obligation, premiums, net investment income, realized investment gains and losses, policyholder benefits, policyholder dividends, and the amount of maximum future earnings remaining to inure to the benefit of stockholders from the assets and liabilities of the closed block as well as an analysis of the changes in the policyholder dividend obligation.

c. GAAP disclosures that typically would be required for the various specific elements included in the closed block need not be made separately for the closed block if the nature of the information for the closed block would not differ significantly from that already included for the reporting entity as a whole. For example, it is not necessary to show a separate schedule of contractual maturities of closed block fixed maturity securities if the relative composition of contractual maturities is similar to those of the reporting entity taken as a whole. However, if the relative maturities of the closed block fixed maturities securities differ from those of the reporting entity taken as a whole, separate disclosures should be made.

Effective Date and Transition

26. This SOP applies to past or future demutualizations or formations of an MIHC. For those that occur after December 31, 2000, this SOP is effective on the date of the demutualization or formation of the MIHC. For a demutualization or formation of an MIHC that occurred on or before December 31, 2000, this SOP, with the exception of paragraph 18, should be applied retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. A stock insurance enterprise that has elected to adopt SOP 95-1 and did not convert from a mutual life insurance enterprise should apply the provisions of paragraph 17 of this SOP retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. Paragraph 18 of this SOP is effective upon issuance with restatement required for those expenses presented in financial statements for any period presented for comparative purposes. Early adoption of this SOP is encouraged.

27. The beginning balance of retained earnings and, if necessary, any other components of stockholders' equity for the earliest year presented, should be adjusted for the effect of restatement or reclassification as of the earliest year restated or reclassified. In the year this SOP is first applied, the financial statements should disclose the effect on income before extraordinary items, net income, and related per share amounts for each year restated. If the actuarial calculation is prepared as of the beginning of the year of adoption of this SOP, its implementation will not result in restatement to recognize a policyholder dividend obligation. Pro forma information for years prior to a demutualization or formation of an MIHC is not required.

The provisions of this Statement need not be applied to immaterial items.

Basis for Conclusions

28. This section discusses considerations that were deemed significant by AcSEC members in reaching the conclusions in this SOP. In April 2000, AcSEC issued for public comment an exposure draft of a proposed SOP, *Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts*. During the sixty-day comment period, twelve comment letters were received by AcSEC.

Financial Statement Presentation of the Closed Block

29. In demutualizations to date, practice has been to aggregate closed block assets and liabilities into two single-line captions (one for assets and one for liabilities), which is similar to the presentation of separate account (as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*) assets and liabilities. In addition, practice has been to present the closed block pretax results of operations on one line in the statement of operations as "contribution from the closed block." AcSEC concluded that that presentation was not the most meaningful for obtaining an understanding of the overall operations of an insurance enterprise.

30. The only products of an insurance enterprise that are displayed on a single-line segregated basis on the balance sheet are those included in separate accounts. AcSEC believes that the closed block is not analogous to pure-pass-through separate account arrangements that are displayed on a single-line basis. One significant difference between a closed block and a separate account is that separate account arrangements transfer substantially all investment risk to the policyholder, whereas closed block policies usually provide minimum guaranteed returns in accordance with contractual provisions that are not altered by establishment of the dividend protection mechanism. Another significant difference is that the insurance enterprise directs investment options for policies in the closed block, whereas the policyholder, not the insurance company (sponsor), of the pure-pass-through separate account directs the allocation of the assets among various investment options. In addition, the rights of a separate account contract- holder and a closed block policyholder differ as to their priority interest in the dedicated assets in the event of insolvency. Whereas separate account assets are often isolated from the general claims of creditors of the insurance enterprise, including other nonseparate account policyholders, closed block assets are not isolated in the event of insolvency.

31. AcSEC believes that management's funding strategy may influence the level of perceived profitability of the closed block if a segregated presentation is used. That may occur because the insurance enterprise selects assets used in funding the closed block, and selection of the assets in part determines the level and timing of earnings that will emerge with respect to the closed block. Therefore, a single-line presentation is less meaningful and may be misinterpreted.

32. AcSEC also believes an integrated presentation of the closed block is consistent with the presentation of other contractual arrangements involving dedicated assets. AcSEC believes that a closed block may be analogous in some respects to certain participating group pension contracts that provide for assets that specifically support obligations to the pension contractholders, as well as payment of policyholder dividends. It is accepted practice to classify assets, liabilities, revenues, and expenses for those contracts among the various financial statement accounts.

33. AcSEC believes there is no substantial economic difference between dividend protection mechanisms that operate through formal identification of assets for inclusion in a closed block and those that do not provide for the formal designation. In either case, the dividend protection mechanism may be most similar to arrangements in which the income that may inure to stockholders of the stock insurance enterprise is limited as described in FASB Statement No. 60, paragraph 42. Policy liabilities for contracts under those arrangements, the assets that support them, and the policyholders' share of the results of operations are commingled among the appropriate accounts of the enterprise, with profits that do not inure to the benefit of stockholders recognized as a liability.

34. Because cash flows of assets of the insurance enterprise other than those of the closed block may be used to support the operation of the closed block, AcSEC believes that a single line presentation of only those assets actually designated to the closed block may be misinterpreted. AcSEC further believes that the benefits of integrated financial statement presentation outweigh the benefit of isolating assets whose cash flows cannot, by contract or regulation, inure to the benefit of stockholders, a restriction that can be readily disclosed in a note similar to the disclosure of other restricted assets.

Accounting for Predemutualization Participating Contracts After the Demutualization Date or Formation of an MIHC and for Stock Insurance Enterprises That Have Adopted SOP 95-1

35. Currently the following three situations exist for demutualized insurance enterprises:

a. Former mutual life insurance enterprises that converted before the effective date of FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, and, as stock insurance companies at the effective date of that Statement, could elect to apply the provisions of SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, to participating policies that meet SOP 95-1 requirements but did not do so

b. Mutual or stock life insurance enterprises that have published GAAP financial statements and have applied SOP 95-1 to those participating contracts that meet SOP 95-1 conditions

c. Mutual life insurance enterprises that have not published GAAP financial statements and, therefore, have not yet applied SOP 95-1

36. AcSEC concluded that insurance enterprises described in the first situation outlined in paragraph 35 of this SOP that have not elected to adopt SOP 95-1 should remain grandfathered because of the provisions of FASB Statement No. 120. For insurance enterprises that fall into the second and third situations in paragraph 35 of this SOP, SOP 95-1 should be used for the qualifying participating policies both before and after demutualization or formation of an MIHC. AcSEC believes that SOP 95-1 is the appropriate accounting guidance for participating policies that meet its requirements and, accordingly, that the insurance enterprises in the second and third situations should apply, or continue to apply, the provisions of SOP 95-1 after the effective date of demutualization or formation of an MIHC.

37. Paragraph 32 of FASB Statement No. 120 states that "the Board believes, however, that there are likely to be only a limited number of stock life insurance enterprises with material amounts of those [participating life insurance] contracts and decided not to require those enterprises to comply with the SOP [for those participating life insurance contracts]." Therefore, it was not the FASB's intention to have life insurance companies with significant amounts of participating contracts that meet the conditions of SOP 95-1 apply FASB Statement No. 60 in its entirety to those contracts.

38. Paragraphs 32 and 34 of FASB Statement No. 120 discuss the FASB's decision to permit rather than require stock life insurance enterprises to apply SOP 95-1 to certain participating contracts as follows:

> 32. The Board recognizes that the information provided to users about the insurance and reinsurance activities of life insurance enterprises could be improved by limiting the diversity among insurance enterprises in accounting and reporting for those activities. The Board acknowledges that permitting stock life insurance enterprises with participating life insurance contracts that meet the conditions in paragraph 5 of this Statement to apply the accounting in the SOP to those contracts may cause inconsistencies between insurance enterprises in their accounting for those contracts. The Board believes, however, that there are likely to be only a limited number of stock life insurance enterprises with material amounts of those contracts and decided not to require those enterprises to comply with the SOP. . . .
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> 34. . . . The Board also believes that a decision to require stock life insurance enterprises to apply the SOP's accounting to those contracts would necessitate adding the accounting conclusions in the SOP to this Statement thereby requiring time-consuming deliberations. The Board decided not to require stock life insurance enterprises to apply the provisions of the SOP because the overall benefits of providing timely guidance on the accounting and reporting of insurance activities by mutual life insurance enterprises outweigh the incremental improvement in the consistency and comparability of financial reporting among insurance enterprises that would result from requiring stock life insurance enterprises to apply the SOP's accounting. . . .

39. AcSEC concluded that the most appropriate accounting for policies of a demutualized insurance enterprise that meet SOP 95-1 scope requirements would be continued application of SOP 95-1 provisions, except that the insurance enterprise should recognize an obligation for future policyholder dividends based on accumulated undistributed earnings in a manner that is consistent with paragraphs 41 and 42 of FASB Statement No. 60. AcSEC believes that the provisions of FASB Statement No. 120 and SOP 95-1 that do not appear to support recognition of such an obligation were intended for mutual life insurance enterprises. Upon conversion to a stock life insurance enterprise, the provisions of paragraphs 41 and 42 of FASB Statement No. 60 are more appropriate to the new stock organization and should be applied to all participating contracts. In paragraph 42 of SOP 95-1, AcSEC acknowledged that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interest may be meaningful in a stock life company because the objective of that presentation is to identify amounts that are not distributable to stockholders. AcSEC concluded that it would be appropriate to follow accounting guidance based on the nature of the contract, and whether the insurance company is a mutual or stock company is significant to the relevance of segregating undistributed accumulated earnings on participating policies. AcSEC believes, however, that the restriction on the stock insurance enterprise's ability to pay certain amounts of undistributed accumulated earnings to the stockholders should be shown as a liability to the policyholders, as discussed below.

Conflict in the Literature on Accounting for Dividends of Participating Contracts

40. Existing GAAP literature distinguishes whether an obligation for future dividends based on accumulated earnings should be recorded for participating policies primarily based on the form of the issuing insurance enterprise, and there is conflicting guidance for insurance enterprises that convert from mutual to stock form. FASB Statement No. 60 requires an insurance enterprise to recognize a liability for future dividends of earnings attributable to a participating contract that cannot be distributed to stockholders; however, SOP 95-1, paragraph 42, does not appear to support the recognition of a liability. Thus, AcSEC had to determine the circumstances in which recognition of a liability is appropriate in accounting for the participating policies that have been and will continue to be accounted for under SOP 95-1 after designation into a closed block.

41. FASB Statement No. 120 states that participating contracts of mutual life insurance enterprises should be accounted for in accordance with FASB Statement Nos. 60 and 97, as appropriate, unless those contracts meet the conditions in paragraph 5 of FASB Statement No. 120. The conditions in that paragraph are the same as the conditions for a participating contract to be within the scope of SOP 95-1.

42. SOP 95-1, paragraph 10, states in part that "FASB Statement No. 60 addresses accounting for traditional forms of participating contracts issued, but does not address the participating contracts issued by mutual life insurance enterprises. . . ." SOP 95-1 also discusses the differences between the participating contracts considered within FASB Statement No. 60 and those considered in SOP 95-1 as follows:

> 30. AcSEC concluded that separate consideration of the participating life insurance contracts covered by [SOP 95-1] is justified by the differences between those contracts and both traditional nonparticipating life insurance contracts, covered by FASB Statement No. 60, and universal life-type contracts, covered by FASB Statement No. 97. Participating life insurance contracts covered under [SOP 95-1] have attributes of the contracts covered by FASB Statement Nos. 60 and 97. AcSEC concluded, therefore, that contracts covered by [SOP 95-1] were not sufficiently similar to those covered by either FASB Statement to warrant applying either of them in its entirety.

43. Paragraph 32 of SOP 95-1 states the following:

> Despite those similarities in form to FASB Statement No. 60 contracts, the dividend feature introduces a variable that affects the substance of the earnings flow to the company. The dividend feature causes the contracts covered by [SOP 95-1] to more closely resemble contracts in which the earnings emerge in relation to margins rather than contracts in which earnings emerge proportional to the level of premiums received in that year. Participating policies covered by [SOP 95-1] share in the results of investment activity, mortality experience, and contract administration costs through dividends, which are not fixed or guaranteed by contract terms. As a result, earnings on those products, after annual policyholder dividends, tend to emerge as the margin recognized on investments, mortality, and expenses.

44. FASB Statement No. 60 states the following in discussing the accounting for policyholder dividends:

> 41. Policyholder dividends shall be accrued using an estimate of the amount to be paid.
>
> 42. If limitations exist on the amount of net income from participating insurance contracts of life insurance enterprises that may be distributed to stockholders, the policyholders' share of net income on those contracts that cannot be distributed to stockholders shall be excluded from stockholders' equity by a charge to operations and a credit to a liability relating to participating policy holders' funds in a manner similar to the accounting for net income applicable to minority interests. Dividends declared or paid to participating policyholders shall reduce that liability; dividends declared or paid in excess of the liability shall be charged to operations. Income-based dividend provisions shall be based on net income that includes adjustments between general-purpose and **statutory** financial statements that will reverse and enter into future calculations of the dividend provision.

> 43. For life insurance enterprises for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends (based on dividends anticipated or intended in determining gross premiums or as shown in published dividend illustrations at the date insurance contracts are made) shall be accrued over the premium-paying periods of the contracts.

45. AcSEC believes that SOP 95-1 is the more appropriate guidance in accounting for participating policies whose provisions meet the criteria of that SOP, whether those policies are issued by a mutual insurance enterprise or were issued by a mutual that converts to a stock insurance company. However, AcSEC believes that the demutualization process changes the nature of the relationship between the enterprise and its policyholders. Therefore, continued application of paragraph 42 of SOP 95-1 in its entirety is not warranted. AcSEC views the new relationship of the closed block policyholders and the insurance enterprise's stockholders as more similar to the relationship that would exist in the situation described in paragraphs 41 and 42 of FASB Statement No. 60 rather than to the relationship that would exist in the situation contemplated in paragraphs 41 and 42 of SOP 95-1. Accordingly, AcSEC believes that the application of the dividend concepts described in paragraph 42 of FASB Statement No. 60 is more appropriate for the participating policies of a demutualized insurance enterprise, whether those policies are issued before or after demutualization.

Emergence of Earnings

46. The process of demutualization or formation of an MIHC does not, in and of itself, change the basis of accounting, other than recognition of a policyholder dividend obligation as discussed in paragraphs 15 and 16 of this SOP; the accounting methods used to measure assets, liabilities, revenues, and expenses remain unchanged. Amortization of **deferred acquisition costs** (DAC) will continue to consider all components of estimated gross margins attributable to the policies, whether the components reside inside or outside the closed block.

47. At the actuarial calculation date, a calculation is developed based on the cash flows expected to be generated from the assets and policy contracts included in the closed block. Based on that calculation, the expected periodic changes in the net closed block liability should be derived (the actuarial calculation). As actual experience emerges, that experience is likely to differ from that expected in the actuarial calculation. Because all the cash flows of the closed block assets and policy contracts will inure to the closed block policyholders pursuant to the plan of demutualization, AcSEC believes that cumulative net favorable experience compared to that contemplated at the actuarial calculation date represents an obligation to closed block policyholders. Such favorable experience will ultimately be paid to closed block policyholders in the form of dividends, unless otherwise offset by future performance of the closed block that is less favorable than originally expected.

48. The concept of establishing a liability for participating insurance contracts where profit limitations exist, and of recording a liability for policyholder dividends on those policies using an estimate of the amount to be paid, is contemplated by paragraphs 41 and 42 of FASB Statement No. 60 and paragraph 77 of FASB Statement No. 97. Paragraph 77 of FASB Statement No. 97 states the following, in part:

> The Board acknowledges that some contracts with policyholders may entitle policyholders to an amount equal to a portion of specific investment performance.

> The recording of liabilities to reflect amounts to which those policyholders are entitled is appropriate, but the deferral of realized gains and losses is not justified.

49. In paragraph 42 of SOP 95-1, AcSEC stated that it is not appropriate or meaningful to segregate undistributed accumulated earnings on participating contracts in the context of a mutual insurance enterprise. However, AcSEC acknowledged in that same paragraph the relevance of such accounting treatment for a stock life insurance company, as follows:

> Annual policyholder dividends of participating contracts covered by this SOP are based on actual company performance. Accordingly, AcSEC believes dividends on participating contracts covered by this SOP are not similar to either of the types of dividends discussed in FASB Statement No. 60. While AcSEC acknowledges that segregating undistributed accumulated earnings on participating contracts in a manner similar to minority interests may be meaningful in a stock life insurance company, it is not meaningful for a mutual life insurance enterprise, because the objective of such presentation is to identify amounts that are not distributable to stockholders.

50. Based on the above guidance, AcSEC believes that the provisions of FASB Statement No. 120 and SOP 95-1 do not recognize the segregation of accumulated earnings on participating contracts for mutual life insurance companies. However, AcSEC believes a mutual life insurance enterprise, upon conversion to a stock life insurance company, should continue to apply SOP 95-1 modified by the provisions of paragraphs 41 and 42 of FASB Statement No. 60 in accounting for SOP 95-1 contracts. In essence, the conversion from a mutual life insurance enterprise to a stock life insurance enterprise creates an additional measurement requirement for accumulated undistributed earnings because of the newly established stockholder constituency. The establishment of a policyholder dividend obligation recognizes that a portion of earnings in certain cases will not inure to the stockholders of the insurance company.

51. Several respondents to the exposure draft of the SOP expressed a view that realization of cumulative closed block earnings in excess of the amount indicated by the actuarial calculation, in and of itself, is insufficient to require recognition of a policyholder dividend obligation and believed that the continued application of SOP 95-1, without modification, was sufficient to measure the emergence of earnings of the closed block. Those respondents acknowledge that earnings in excess of the amount indicated by the actuarial calculation would be reasonably expected to be returned to policyholders through adjustment of dividend scales, but believe that the obligating event required for accounting recognition takes place upon the actual adjustment of the dividend scales rather than at the earlier date at which the earnings are measured. Those respondents believe that the regulatory supervision of the activity of the closed block results in timely adjustments of the dividend scales, and the recordkeeping requirements necessary for the establishment of a policyholder dividend obligation do not meet a cost/benefit test. Although the actual adjustment of the dividend scales is a necessary condition for identification of the recipients of the amounts to be distributed, AcSEC does not believe that such identification is a necessary prerequisite for accounting recognition under the guidance of FASB Statement of Accounting Concepts No. 6, *Elements of Financial Statements*. Paragraph 36 of FASB Concepts Statement No. 6 states the following, in part:

> Liabilities commonly have other features that help identify them—for example, most liabilities require the obligated entity to pay cash to one or more identified

> other entities and are legally enforceable. However, those features are not essential characteristics of liabilities. . . . That is, liabilities may not require an entity to pay cash but to convey other assets, to provide or stand ready to provide services, or to use assets. And the identity of the recipient need not be known to the obligated entity before the time of settlement.

52. AcSEC believes that given the regulatory supervision of operations of a closed block, the insurance enterprise has only limited discretion as to the timing of its adjustment of dividend scales under the circumstances where this SOP requires recognition of a policyholder dividend obligation but cannot adjust those dividend scales contemporaneously. AcSEC also believes that, at a given point, assets in excess of the amounts contemplated at the actuarial calculation date represent undistributed accumulated earnings that ultimately will be distributed to policyholders under the terms of the closed block agreements unless offset by future experience less favorable than that indicated by the actuarial calculation. Those incremental assets, therefore, will not become available for distribution to stockholders. Accordingly, AcSEC believes that the usefulness of financial statements may be compromised if the obligation is not recognized until the actual adjustment of dividend scales takes place.

53. Several respondents to the exposure draft of the SOP expressed a belief that recognition of a policyholder dividend obligation under the circumstances when it would be required under the guidance herein would result in a pattern of income recognition based on a predetermined actuarial calculation and therefore would not be appropriately responsive to changes in experience of the closed block. However, AcSEC believes that in the absence of a policyholder dividend obligation for participating policies in the closed block if there are closed block cumulative earnings in excess of the amount indicated by the actuarial calculation, earnings and net assets reported to stockholders will fail to recognize the obligation of the insurance company to distribute excess returns from the designated assets to the closed block policyholders in future periods. The recognition of favorable experience deviations that will not inure to stockholders as earnings would result in reduced earnings when the results of that experience are ultimately distributed by means of increased dividends to closed block policyholders. As a consequence, the integrity and usefulness of financial statements during periods if there are cumulative earnings in excess of the amount indicated by the actuarial calculation may be compromised by reporting amounts as earnings of stockholders that those stockholders cannot ultimately realize.

54. AcSEC also considered whether it would be appropriate to recognize a negative balance in the policyholder obligation account in the event of the following:

a. There is cumulative experience of the closed block less favorable than anticipated in the actuarial calculation.

b. The insurance company expects to reduce future dividends or anticipates future favorable performance of the closed block.

Net unfavorable deviations may result in reduced dividends to closed block policyholders, unless offset by future favorable experience of the closed block or subsidized by the insurance company using assets outside of the closed block. Although some, including several respondents to the exposure draft of the proposed SOP, believe that a policyholder dividend receivable is a consistent extension of the policyholder dividend obligation concept and it could be potentially recoverable based on future dividend adjustments, AcSEC believes that recognition of a negative balance as an asset is not supported by paragraph 42 of FASB Statement No. 60. Due to competitive pressures and other considerations, the board of directors of an insurance enterprise may choose not to reduce dividends to closed block policyholders. If an insurance enterprise has favorable experience it is compelled to pass it along to the closed block policyholders. If the insurance enterprise has unfavorable experience, the insurance enterprise has the ability to pass it on but may be constrained by the marketplace in its ability to do so.

Determination of the Policyholder Dividend Obligation

55. AcSEC determined that cumulative net favorable experience of the closed block in relation to expectations indicated by the actuarial calculation that will be paid to policyholders, unless otherwise offset by future performance of the closed block that is less favorable than expected in the actuarial calculation, should not be reflected in earnings of stockholders for the reasons previously discussed in the "Emergence of Earnings" section.

56. Therefore, in the absence of unusual circumstances, the maximum earnings from closed block assets and liabilities that will inure to stockholders is the amount of closed block liabilities in excess of the closed block assets, adjusted for the related items in accumulated other comprehensive income at the actuarial calculation date. Further, AcSEC believes that experience gains and losses of the closed block ultimately may result in an adjustment of dividends or other variable policy benefits paid to policyholders. Therefore, the actuarial calculation provides the expected earnings to be used by the insurance enterprise to measure net positive experience that should not be reflected in the earnings of stockholders.

57. This SOP requires the portion of the unrealized investment gains and losses that have arisen after the actuarial calculation date to be included in the determination of the amount of the policyholder dividend obligation. AcSEC determined that it was necessary to separate the portion of unrealized investment gains and losses that are attributable to the policyholders and not the stockholders; such amounts should be displayed fully and not netted in the presentation of other comprehensive income, as appropriate. In reaching that conclusion, AcSEC considered the guidance in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, to determine the treatment of unrealized and realized gains and losses of closed block assets. Under FASB Statement No. 115, assets classified as available-for-sale are reported at fair value with unrealized gains and losses excluded from earnings as a separate component of stockholders' equity until realized.

58. AcSEC considered whether the actuarial calculation should be revised after the actuarial calculation date for purposes of revising the measurement described above. One alternative considered was to revise the actuarial calculation at each financial reporting date. Under that approach, the measurement of excess experience gains would be based on the current estimate (giving effect to past events and current expectations for future events) of the timing of maximum closed block earnings inuring to stockholders. AcSEC believes that the principal assumptions other than investment performance affecting the timing of stockholder earnings from the closed block over the long-term would be persistency and mortality. Persistency and mortality affect the assumed amount of life insurance **in force** and the life of the block of business, which are key factors in the recognition of stockholder earnings. Cash flow effects of differences between assumptions and actual should result in revised dividends or policy benefits to policyholders. AcSEC rejected frequent revisions of the actuarial calculation because short-term movements in persistency and mortality for a block of business with a life of up to 100 years should not have a significant effect on the timing of recognizing earnings that will ultimately be realized by stockholders. AcSEC believes that the "lock in" alternative is most appropriate because the actuarial calculation is developed solely to measure the performance of the closed block in relation to a maximum amount of earnings that will inure to stockholders. Negative performance in relation to the actuarial calculation is recognized currently, and positive performance is recognized as a policyholder dividend obligation. AcSEC also believes periodic loss-recognition tests would identify situations in which significant negative experience should result in the recognition of additional losses to stockholders. Further, AcSEC believes the purpose of the actuarial calculation is to serve as an approach to measure aggregate favorable experience that will not inure to stockholders and may not achieve the intended objective if the actuarial calculation is revised.

59. AcSEC also considered whether the actuarial calculation should be revised upon (*a*) the occurrence of a significant unanticipated event, (*b*) the determination that there has been a significant change in the assumptions for persistency or mortality, or (*c*) the designation of significant additional assets for the closed block that would not revert to the stockholders. AcSEC rejected that approach because the actuarial calculation is a measure of the maximum amount of earnings that would be recognized over the life of the block of business. Actual results of the closed block will flow into stockholder income unless cumulative earnings to date are in excess of the maximum that can be recognized based on the actuarial calculation. Therefore, positive performance of the closed block in relation to the actuarial calculation results in a policyholder dividend obligation, and negative performance results in either reduced dividends to closed block participating policyholders or lower earnings than anticipated at the actuarial calculation date. Cumulative negative performance of the closed block represents an amount included in the excess of closed block liabilities over closed block assets that may have to be funded with assets outside the closed block unless offset by future positive performance of the closed block or reduced policyholder dividends. It is believed that a designation of additional assets for the closed block business would result from historical negative performance of the closed block. This negative performance would have been recognized in income as it occurred because negative performance in relation to the actuarial calculation does not result in recognition of an asset.

Accounting for Participating Policies Sold After the Date of Demutualization or the Formation of an MIHC

60. AcSEC considered whether a demutualized insurance enterprise should apply FASB Statement No. 60 or SOP 95-1 to participating policies sold after the date of demutualization or the formation of an MIHC. AcSEC concluded that a demutualized insurance enterprise should continue to apply SOP 95-1 to participating policies that meet the scope requirements of SOP 95-1. If the scope requirements of SOP 95-1 are not met, FASB Statement Nos. 60 or 97 should be applied. In the application of SOP 95-1, the stock insurance enterprise should recognize an obligation for future policyholder dividends based on accumulated undistributed earnings in a manner that is consistent with paragraphs 41 and 42 of FASB Statement No. 60. (See paragraph 39 of this SOP for the basis for establishing an obligation for future policyholder dividends for SOP 95-1 policies.)

Accounting for Demutualization and MIHC Expenses

61. Paragraph 20 of Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, provides the two criteria that must be met for an event or transaction to be classified as an extraordinary item as stated in part below:

> Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Thus, both of the following criteria should be met to classify an event or transaction as an extraordinary item:
>
> *a.* Unusual nature—The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
>
> *b.* Infrequency of occurrence—The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

62. Demutualizations and formations of MIHCs are changes in legal forms of organizations. Several respondents to the exposure draft of the proposed SOP said that demutualizations and formations of MIHCs satisfy the above criteria and that the associated costs should therefore be classified as an extraordinary item. However, AcSEC believes that the events represent consequences of customary and continuing activities in efforts to remain competitive in the financial services industry. AcSEC believes that such events do not possess a sufficient degree of abnormality required by paragraph 20(a) of APB Opinion 30. AcSEC recognizes that the prior practice in demutualizations to date has been to classify such costs as extraordinary. However, AcSEC considered the environment in which the insurance industry operates and the nature of the activities of the individual mutual insurance enterprises which have continued to evolve in recent years. AcSEC believes a demutualization has characteristics similar to other forms of corporate reorganizations and restructurings in which costs do not meet the criteria for extraordinary treatment. Because one of the criteria of paragraph 20 of APB Opinion 30 is met, the direct incremental costs associated with a demutualization or formation of an MIHC should be reported as a separate component of income from continuing operations. Further, AcSEC believes that such classification of expenses should be limited to costs that are direct and incremental to the transaction and should not include allocations of general and administrative-type costs.

Accounting for Retained Earnings and Other Comprehensive Income at the Date of Demutualization or Formation of an MIHC

63. Stockholders' equity usually is displayed in two broad categories: contributed or paid-in capital and retained earnings. Contributed or paid-in capital represents the amount provided by stockholders or resulting from subsequent transactions with stockholders. Retained earnings represents the amount of the enterprise's previous income that has not been distributed to owners as dividends or transferred to contributed or paid-in capital.

64. A demutualization is a change in legal form of organization "from a form of organization that has no substantive equity ownership to one that has"

(FASB Technical Bulletin 85-5, *Issues Relating to Accounting for Business Combinations*, paragraph 24); thus, the distribution of shares of stock represents the distribution of the then-existing equity to the owners of the mutual insurer's equity. Several respondents to the exposure draft of the proposed SOP said that because a demutualization does not, in and of itself, result in a change of the historical carrying values of the assets and liabilities of the resulting stock insurance enterprise, the transaction also should not result in the reclassification of accumulated retained earnings as of the demutualization date. AcSEC believes, however, that it is appropriate to reflect the substance of this transaction by reclassifying accumulated retained earnings as of the demutualization date to the capital stock and additional paid-in capital accounts. Therefore, AcSEC concluded that all retained earnings after capital transactions resulting from the demutualization should be reclassified, as of the demutualization date, to capital stock and paid-in capital accounts for a distribution-form demutualization.

65. This SOP uses the term *subscription-form demutualization* to refer to situations in which eligible policyholders receive only the right to purchase stock in the insurance enterprise or its parent at terms essentially equivalent to the terms offered to independent third parties. AcSEC believes that a subscription-form demutualization is very similar to the kinds of demutualizations that have taken place in the savings and loan industry. Consistent with practice for those kinds of transactions that has not resulted in a reclassification of retained earnings, AcSEC concluded that a subscription-form demutualization does not, by itself, result in reclassification of retained earnings because retained earnings are not being distributed.

66. The process of demutualization or formation of an MIHC does not, by itself, change the basis of accounting, and therefore there is no change in other comprehensive income. As of the actuarial calculation date, the existing accumulated other comprehensive income may relate to items included in the closed block. At the actuarial calculation date, existing accumulated other comprehensive income items related to the closed block should be identified and segregated in the financial records of the insurance enterprise. For example, unrealized investment gains and losses reflect the present value of the difference between market interest rates and the stated interest rates of the closed block fixed income securities or unrealized appreciation or depreciation of closed block equity securities at the actuarial calculation date. As with all such assets, the future contribution to earnings that will be recognized in the financial statements associated with those assets will be based on their cost or amortized cost. Therefore, existing unrealized investment gains and losses will be part of net investment income or realized investment gains when realized. Accordingly, the actuarial calculation of the earnings of the closed block should be determined on the basis of cost or amortized cost of the invested assets at the actuarial calculation date.

Accounting for the Dividends From a Stock Insurance Subsidiary to an MIHC

67. Subsequent to the formation of an MIHC and conversion of the mutual insurer to a stock insurance company, the stock insurer's board of directors would be expected to declare and pay cash dividends to its stockholders as deemed appropriate in view of the insurer's operating results and capital needs. The National Association of Insurance Commissioners' whitepaper titled *Mutual Insurance Holding Company Reorganizations* indicates that states should "prohibit the MIHC from waiving dividends payable by its stock subsidiaries to ensure that dividend earnings are received by the MIHC and are therefore available to benefit its members." For example, Iowa law protects member interests in earnings distributions by assuring that the class of stock held by the MIHC has dividend and other rights no less favorable than any other class of stock. A dividend declared by a stock insurer (or its holding company, or both) payable to its stockholders is a standard corporate capital transaction and should be accounted for accordingly.

Accounting for a Distribution From an MIHC to Its Members

68. Dividends or other distributions may be made to the MIHC by the insurer or intermediate holding company. At some point, it is possible the MIHC board of directors, with the concurrence of the insurance regulator, may conclude that it is appropriate to distribute some portion of the MIHC's accumulated funds to or on behalf of the members. The form of this distribution could be cash directly to the members or it could be in the form of policy credits, additional policy benefits, or both, purchased by the MIHC from the subsidiary insurance company.

69. Membership interests are not securities under the federal securities laws; the Uniform Commercial Code defines a security as an "obligation of an issuer or a share, participation or other interest in an issuer or in property or an enterprise of an issuer . . . and which by its terms is divisible into a class or series of shares, participations, interests or obligations. . . ." There is an argument that because membership interests are not securities and have not been unitized, members do not have "equity" interests. It is conceptually difficult to argue that a distribution is a capital transaction when the recipient does not have an equity interest. One might compare a member distribution with a patronage refund made by a cooperative, which is a distribution of allocated member-sourced earnings to members and is recorded as a capital transaction. However, the same analogy could be made for policyholder dividends, which are accounted for as expenses.

70. Some respondents to the exposure draft of the proposed SOP requested that AcSEC not provide guidance on MIHC distributions until the related legal and tax issues have been more thoroughly examined. However, AcSEC believes it is appropriate to provide conceptual guidance related to MIHC distributions, which it believes should be applied to those transactions so that they will be accounted for in accordance with their economic substance. Because of the ongoing dual relationship of MIHC members as policyholders of the insurance subsidiary, the distributions from the MIHC to its members, whether made directly or through the purchase of contract benefits from its insurance subsidiary, should be accounted for at fair value based on an evaluation of the specific facts and circumstances. AcSEC believes that the threshold criteria that need to be present to constitute a capital transaction are the following:

a. The existence of substantive independent third-party stockholders in the stock life insurance subsidiary or intermediate holding company

b. An equivalence in the dividend from the MIHC to its members relative to the dividends from the stock life subsidiary or intermediate holding company

Until there are substantive independent third-party stockholders, a distribution should not be accounted for as a capital transaction.

71. MIHC distributions accounted for as dividends would have no impact on the insurance company's or intermediate holding company's net income, except to the extent the MIHC purchased policy credits and benefits from the insurance company. If the purchase of policy credits and benefits were on the same terms as available to third parties (considering the impact of lower or nonexistent acquisition costs), the insurance company would account for the policy credits and benefits in the same manner as for third-party transactions.

72. MIHC distributions accounted for as policyholder dividends would result in the insurance company reflecting a policyholder benefit expense for the amount of the dividend distribution and a capital contribution from the MIHC in an equal amount. The MIHC would reflect the amount of the distribution as a capital contribution to the insurance subsidiary.

Disclosures

73. If the financial statements of the reporting entity include disclosures for assets, liabilities, revenues, and expenses that are attributed to the closed block in whole or in part, a determination shall be made about whether disclosures of similar data for the closed block elements alone would be similar, in all material respects, to that related to the financial statements of the reporting entity. For example, depending on the debt securities included in the closed block, the contractual maturity information disclosed as of the date of the most recent statement of financial position presented as required by FASB Statement No. 115, paragraph 20, may be materially consistent for closed block assets to that presented for the reporting entity. For any such items where disclosure related to the closed block item would not be consistent, in all material respects, to that presented for the reporting entity, disclosure for the particular closed block items should be presented separately.

74. Several respondents to the exposure draft of the proposed SOP suggested that the disclosures, as illustrated in appendix A, are more extensive than necessary. AcSEC's intention was to provide an illustrative reference for auditors and preparers of financial statements to become familiar with the mechanics of the numbers involved in typical disclosures. The level of detail in appendix A is not required but is intended to be illustrative.

Effective Date and Transition

75. AcSEC acknowledged the practical concerns, identified by a number of respondents to the exposure draft of the proposed SOP, associated with implementation of the transition provisions proposed in the exposure draft that would have required restatement of all earlier financial statements presented by insurance enterprises that had demutualized or formed an MIHC prior to the issuance of this SOP. AcSEC believes that companies should prepare the actuarial calculation as of the date of demutualization or formation of an MIHC. In rare circumstances, it may not be practicable to prepare the actuarial calculation as of such date because an enterprise demutualized many years prior to January 1, 2001, and the information needed to prepare the calculation as of such date is not available or to do so would be a time-consuming and expensive process; under those circumstances the calculation may be prepared as of the beginning of the year of adoption of this SOP.

76. In those rare circumstances when it is not practicable, for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, to prepare the actuarial calculation as of the date of demutualization or formation of an MIHC as described above, the actuarial calculation described in paragraph 16 is prepared as of the beginning of the year of adoption of this SOP. In those circumstances, the SOP's implementation will not result in restatement to recognize a policyholder dividend obligation and there will not be a cumulative effect resulting from the implementation of this SOP.

77. AcSEC concluded that for a demutualization or formation of an MIHC that occurs after December 31, 2000, this SOP should be effective on the date of the demutualization or formation of the MIHC. AcSEC also considered the financial reporting for demutualizations or formations of an MIHC that occurred on or before December 31, 2000. For those transactions, AcSEC believes that improved reporting is needed as soon as practicable, and that the benefits of comparability outweigh the costs and efforts of restatement of earlier periods presented. Accordingly, AcSEC concluded that financial statements of earlier periods presented should be restated to conform to the SOP's provisions. However, AcSEC notes that certain entities may not have readily available information to comply with the provisions of paragraphs 16 and 17 of this SOP for prior periods, and that entities that are engaged in the transactions covered by this SOP may require modifications to their systems and procedures to conform with the provisions of this SOP. To allow adequate time for implementation, an entity that demutualized or formed an MIHC on or before December 31, 2000, should apply this SOP, with the exception of paragraph 18, retroactively through restatement or reclassification, as appropriate, of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. AcSEC also concluded that a stock insurance enterprise that has elected to adopt SOP 95-1 and did not convert from a mutual life insurance enterprise should apply the provisions of paragraphs 41 and 42 of FASB Statement No. 60 retroactively through restatement of all previously issued financial statements no later than the end of the fiscal year that begins after December 15, 2000. However, the provision of paragraph 18 of this SOP, to report expenses associated with a demutualization or formation of an MIHC as a single line item within income from continuing operations is effective upon issuance of this SOP. Accordingly, presentation of those expenses presented in financial statements for any period presented for comparative purposes should be restated, if necessary.

APPENDIX A

Illustrative Guidance—Footnote Disclosure for the Closed Block

A.1. This Appendix provides specific examples that illustrate the disclosures that this Statement of Position (SOP) requires and depicts the application of certain principles of this SOP. The formats and level of detail, including the shaded areas, in the illustrations are not requirements. The Accounting Standards Executive Committee (AcSEC) encourages a format that provides the information in the most understandable manner in the specific circumstances. Entities are not required to display the disclosure information contained herein in the specific manner illustrated. Alternative ways of disclosing the information are permissible as long as the disclosure requirements of this SOP, as described in paragraphs 24 and 25, are met. The following illustrations are for a single hypothetical insurance enterprise, referred to as ABC Life Insurance Company.

Example Footnote Disclosures for the Closed Block

X. Policy Footnote (in Part) Related to the Demutualization

At the effective date (January XX, 20X1) of the Plan of Demutualization, eligible policyholders received, in the aggregate, approximately $XX million of cash, $XX million of policy credits, and XX million shares of common stock of ABC Holding Company in exchange for their membership interests in ABC Life Insurance Company. The demutualization was accounted for as a reorganization. Accordingly, ABC Life Insurance Company's retained earnings at the Plan Effective Date (net of the aforementioned cash payments and policy credits, which were charged directly to retained earnings) were reclassified to common stock and capital in excess of par.

Z. Closed Block

As of January XX, 20X1, ABC Life Insurance Company established a closed block for the benefit of certain classes of individual participating policies for which ABC Life Insurance Company had a dividend scale payable in 20X0 and that were in force on January XX, 20X1. Assets were allocated to the closed block in an amount that, together with anticipated revenues from policies included in the closed block, was reasonably expected to be sufficient to support such business, including provision for payment of benefits, certain expenses, and taxes, and for continuation of dividend scales payable in 20X0, assuming experience underlying such scales continues. Assets allocated to the closed block inure solely to the benefit of the holders of the policies included in the closed block and will not revert to the benefit of stockholders of ABC Life Insurance Company. No reallocation, transfer, borrowing, or lending of assets can be made between the closed block and other portions of ABC Life Insurance Company's general account, any of its separate accounts, or any affiliate of ABC Life Insurance Company without the approval of the Z State Insurance Department.

If, over time, the aggregate performance of the closed block assets and policies is better than was assumed in funding the closed block, dividends to policyholders will be increased. If, over time, the aggregate performance of the closed block assets and policies is less favorable than was assumed in the funding, dividends to policyholders could be reduced.

The assets and liabilities allocated to the closed block are recorded in ABC Life Insurance Company's financial statements on the same basis as other similar assets and liabilities. The carrying amount of closed block liabilities in excess of the carrying amount of closed block assets at the date of demutualization (adjusted to eliminate the impact of related amounts in accumulated other comprehensive income) represents the maximum future earnings from the assets and liabilities designated to the closed block that can be recognized in income over the period the policies in the closed block remain in force. ABC Life Insurance Company has developed an actuarial calculation of the timing of such maximum future stockholder earnings, and this is the basis of the policyholder dividend obligation.

If actual cumulative earnings are greater than expected cumulative earnings, only expected earnings will be recognized in income. Actual cumulative earnings in excess of expected cumulative earnings represents undistributed accumulated earnings attributable to policyholders, which are recorded as a policyholder dividend obligation because the excess will be paid to closed block policyholders as an additional policyholder dividend unless otherwise offset by future performance of the closed block that is less favorable than originally expected. If actual cumulative performance is less favorable than expected, only actual earnings will be recognized in income.

The principal cash flow items that affect the amount of closed block assets and liabilities are premiums, net investment income, purchases and sales of investments, policyholders' benefits, policyholder dividends, premium taxes, and income taxes. The principal income and expense items excluded from the closed block are management and maintenance expenses, commissions and net investment income, and realized investment gains and losses of investment assets outside the closed block that support the closed block business, all of which enter into the determination of total gross margins of closed block polices for the purpose of the amortization of deferred acquisition costs. The amounts shown in the following tables for assets, liabilities, revenues, and expenses of the closed block are those that enter into the determination of amounts that are to be paid to policyholders.

Summarized financial information for the closed block follows (in millions):

The shaded information is intended to depict the application of the principles of this SOP, and does not represent required disclosure.

[*Table follows.*]

	December 31, 20X2	20X2 Activity*	December 31, 20X1
Closed block liabilities:			
Future policy benefits and policyholder account balances	$8903	$ (8) B	$8911
Policyholder dividends payable	88		88
Policyholder dividend obligation	163	93 E (10)C	80
Other closed block liabilities	12		12
Total closed block liabilities	9166	75	9091
Assets designated to the closed block:			
Fixed maturities:			
Held to maturity, at amortized cost (estimated fair value, 20X2, $275; 20X1, $319)	289		289
Available for sale, at estimated fair value (amortized cost, 20X2, $3,809; 20X1, $3,502)	4001	307 D 93 E	3601
Equity securities, at estimated fair value	202		202
Mortgage loans on real estate	1273	(307)D	1580
Policy loans	1766		1766
Real estate	105		105
Short-term investments	62		62
Cash and cash equivalents	119	82 A	37
Other closed block assets	76		76
Total closed block assets	7893	175	7718
Excess of reported closed block liabilities over assets designated to the closed block	1273	(100)	1373
Portion of above representing other comprehensive income			
— increase in unrealized appreciation	192	93	99
— increase in policyholder dividend obligation	(93)	(93)	
Total	99	0	99
Maximum future earnings to be recognized from closed block assets and liabilities	$1372	$(100)	$1472

* Assumed 20X2 activity for assets and liabilities (similarly identified in statement of operations as applicable):

A items are assumed settled in cash, with net impact reflected in "Cash and cash equivalents."

B and C are given effect in their respective balance sheet accounts.

D represents the assumed sale of mortgage loans at book value and reinvestment of the proceeds in available-for-sale fixed maturities.

E represents the increase in unrealized appreciation on available-for-sale securities held at both December 31, 20X1 and December 31, 20X2. It is assumed that there are no related taxes and that the available-for-sale fixed maturities sold (see above) had fair value equal to book value both at December 31, 20X1, and when sold.

It is further assumed that the unrealized appreciation at December 31, 20X1, is equal to that at the date of demutualization. Unrealized appreciation that arises since the date of demutualization is to be included in the determination of the policyholder dividend obligation.

Change in Policyholder Dividend Obligation:

	December 31, 20X2	*December 31, 20X1*
Balance at beginning of year	$ 80	$ 0
Impact on net income before income taxes	(10)	5
Unrealized investment gains (losses)	93	75
Balance at end of year	$163	$80

Change in Other Comprehensive Income:

	December 31, 20X2	*Change for 20X2*	*December 31, 20X1*
Fixed maturities available for sale:			
Fair value	$4001	$400	$3601
Amortized cost	3809	307 D	3502
Unrealized appreciation	$ 192	$ 93 E	$ 99

	20X2	*20X1*
Closed Block Operations:		
Closed block revenues:		
Premiums	$ 303 A	$ 318
Net investment income	205 A	215
Realized investment gains (losses)	(2) A	10
Other closed block revenues	5 A	5
Total closed block revenues	511	548
Closed block benefits and expenses:		
Policyholder benefits	402 A	376
Change in policyholder benefits and interest credited to policyholder account balances	(8) B	17
Dividends to policyholders	8 A	8
Change in policyholder dividend obligation	(10) C	5
Other closed block expenses	10 A	10
Total closed block benefits and expenses	402	416
Closed block revenues, net of closed block benefits and expenses, before income taxes	109	132
Income taxes	9 A	10
Closed block revenues, net of closed block benefits and expenses and income taxes	$ 100	$ 122
Maximum future earnings from closed block assets and liabilities:		
Beginning of year	$1,472	$1,594
End of year	1,372	1,472
Change during the year	$ (100)	$ (122)

APPENDIX B

Illustrations for Accounting for Closed Block Business

B.1. The accompanying schedules illustrate the accounting for closed block business (meaning those assets and liabilities both inside and outside of the closed block that relate to or support the closed block policies) after the demutualization date. The illustrations display the computations involved in (*a*) determining the amount of the policyholder dividend obligation (PDO) (*b*) deriving estimated gross margins (EGM) for purposes of amortizing deferred acquisition costs (DAC) and (*c*) revising EGM as actual experience emerges.

B.2. To simplify the example, the illustrations assume the closed block has not been funded for income taxes. In practice, the closed block may or may not be funded for income taxes. If the closed block is funded for income taxes, the actuarial calculation would be constructed on a post-tax basis. However, for the purpose of determining PDO and EGM, pretax amounts should be used. Generally, this would be accomplished by converting post-tax actuarial calculation values to corresponding pretax values for purposes of determining EGM and PDO amounts. If the closed block is funded for income taxes, a change in income tax rates would result in an experience gain or loss that would affect closed block cash flows and, therefore, estimated gross margins and amortization of deferred acquisition costs.

B.3. Schedule 1 is the illustration of the computation of estimated gross margins that appears in schedule 1 of appendix A, "Illustration of Computation of Gross Margins," of Statement of Position 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*. This schedule illustrates the projection of the estimated gross margins of the closed block business. The closed block business is assumed to be written in year 1, with demutualization occurring at the end of year 5.

B.4. Schedule 2 illustrates the contribution to the EGM in Schedule 1 from the closed block (meaning, those assets and liabilities actually included in the closed block). As discussed more fully in paragraph 15 of this Statement of Position, this schedule is based on the actuarial calculation for the closed block developed at the demutualization date and represents the expected changes in the net closed block liability (closed block deficit) over the life of the closed block. The data in this schedule will be compared to actual results throughout the life of the closed block to determine the need for a PDO (as illustrated in footnote X). Schedule 2 depicts an increase in interest rates in year 6 from 8.5 percent to 9.5 percent, which results in the board of directors increasing dividends in years 7 through 10. All other assumptions are held constant.

B.5. Schedule 3 illustrates the closed block business EGM contribution associated with the assets and liabilities outside of the closed block. Schedule 3 also shows the total EGM's used to amortize DAC for the closed block business. Those EGMs differ from those shown in schedule 1 based on the emergence of actual experience in year 6 and the creation of the PDO.

Schedule 1—Computation of Estimated Gross Margins*

Year	Premium	Interest on NLPR	Interest on Current Activity	Death Benefits Incurred	Surrender Benefits Incurred	Recurring Expenses Incurred	(Increase) Decrease in NLPR	Dividends Incurred	Post-dividend Gross Margins	Revised Gross Profit at Year 2
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	
1	$ 210,000	$ 0	$ 16,244	$ (9,000)	$ 0	$ (18,900)	$(126,103)	$ (18,857)	$ 53,384	$ 53,384
2	184,611	10,719	14,280	(10,549)	0	(16,615)	(109,116)	(21,399)	51,931	50,546
3	169,621	19,994	13,120	(13,731)	(7,148)	(15,266)	(93,669)	(24,230)	48,691	47,419
4	155,763	27,955	12,048	(14,835)	(14,984)	(14,019)	(79,754)	(26,574)	45,600	44,432
5	142,990	34,735	11,060	(15,661)	(21,760)	(12,869)	(67,117)	(28,509)	42,869	41,797
6	131,222	40,440	10,150	(15,622)	(17,237)	(11,810)	(73,236)	(30,043)	33,864	32,880
7	124,333	46,665	9,617	(16,578)	(20,989)	(11,190)	(66,499)	(32,301)	33,058	32,126
8	117,768	52,317	9,109	(16,824)	(24,427)	(10,599)	(60,005)	(34,367)	32,972	32,089
9	111,526	57,417	8,627	(17,526)	(27,566)	(10,037)	(53,706)	(36,230)	32,505	31,669
10	105,582	61,982	8,167	(18,603)	(30,406)	(9,502)	(47,485)	(37,915)	31,820	31,028
11–20	779,517	760,283	60,296	(311,112)	(398,831)	(70,157)	(162,077)	(424,092)	233,827	227,980
21–55	589,392	1,222,685	45,589	(1,187,632)	(686,079)	(53,041)	938,767	(669,668)	200,013	195,591
Total	$2,822,325	$2,335,192	$218,307	$(1,647,673)	$(1,249,427)	$(254,005)	$ (0)	$(1,384,185)	$840,534	$820,941
Present values at an earned rate of 8.5 percent:									$371,261	$362,945

Explanation of columns:

(a) Gross premiums.

(b) Interest, at 8.5 percent earned rate, on net level premium reserve (NLPR) at the end of the previous year. The NLPR is based on guaranteed mortality and the dividend fund interest rate.

(c) Interest, at the 8.5 percent earned rate, on current-year cash flow. This illustration assumes premiums are received, and all expenses incurred, at the start of the year. This illustration assumes death benefits, surrender benefits, and dividends are all at the end of the year.

(d) Death benefits, not reduced by related NLPR.

(e) Surrender benefits, not reduced by related NLPR.

(f) Recurring expenses not included in capitalized acquisition costs.

(g) Net decrease (increase) in aggregate NLPR in the year.

(h) Policyholder dividends for the year.

(i) Sum of (a) through (h) inclusive.

* This schedule is taken from *SOP 95-1, appendix A, "Illustration of Computation of Gross Margins"*.

Schedule 2—Closed Block Components

Year	Premium	Interest on Closed Block Assets	Interest on Current Activity	Death Benefits Incurred	Surrender Benefits Incurred	(Increase) Decrease in NLPR	Dividends Incurred	Estimated Gross Margin	(Increase)/ Decrease in Policyholder Dividend Obligation	Closed Block Initial Estimated Gross Margin
	(a)	(b)	(c)	(d)	(e)	(g)	(h)	(i)	(j)	(k)
1–5	n/a	n/a	n/a	n/a	n/a	(475,759)	n/a	n/a	n/a	n/a
6	$ 131,222	$ 11,200	$ 12,466	$ (15,622)	$ (17,237)	$ (73,236)	$ (30,043)	$ 18,750	$(2,491)	$ 16,259
7	124,333	17,839	10,568	(16,578)	(20,989)	(66,499)	(33,061)	15,613	549	16,162
8	117,768	24,819	10,010	(16,824)	(24,427)	(60,005)	(35,127)	16,214	595	16,809
9	111,526	31,298	9,480	(17,526)	(27,566)	(53,706)	(36,990)	16,515	646	17,161
10	105,582	37,266	8,974	(18,603)	(30,406)	(47,485)	(38,675)	16,653	701	17,354
11–20	779,517	585,648	66,259	(311,112)	(398,831)	(162,077)	(424,092)	135,312	0	135,312
21–55	589,392	1,103,633	50,099	(1,187,632)	(686,079)	(938,767)	(669,668)	138,512	0	138,512
Total	$1,959,340	$1,811,703	$167,856	$(1,583,897)	$(1,205,535)	$ 0	$(1,267,656)	$357,569	$ (0)	$357,569

Remarks:

1) Example assumes demutualization begins in year six.
2) Expenses assumed to be excluded from the closed block.
3) Closed Block policyholder dividend obligation (PDO) Calculation * Cumulative Closed Block EGM:

Actual as of Measurement Date	$18,750
- Initial Actuarial Calculation	$16,259
= PDO at Measurement Date	$ 2,491

4) Shaded figures indicate differences from the example shown in Schedule 1.

Notes:

(g.) (475,759) represents the cumulative (increase) decrease in net level premium reserve (NLPR) reported in Schedule 1, column (g) for years one to five
(j.) PDO as of end of last year minus PDO as of end of current year.
(k.) (i) + (j)

Schedule 3—Open Block Components

Year	Interest on Open Block Assets	Interest on Current Activity	Recurring Expenses Incurred	Open Block EGM	Closed Block EGM	Total EGM	DAC Amortization
	(b)	*(c)*	*(f)*	*(i)*	*(k)*	*(l)*	(m)
1–5	n/a	n/a	n/a	n/a	n/a	$242,474	$ 63,336
6	$ 33,998	$ (1,122)	$ (11,810)	$ 21,066	$ 16,259	$ 37,324	$ 9,409
7	29,037	(951)	(11,190)	16,896	16,162	33,058	7,263
8	27,663	(901)	(10,599)	16,163	16,809	32,972	7,854
9	26,234	(853)	(10,037)	15,344	17,161	32,505	8,248
10	24,776	(807)	(9,502)	14,467	17,354	31,821	8,535
11–20	174,635	(5,963)	(70,157)	98,515	135,312	233,827	66,591
21–55	119,052	(4,510)	(53,041)	61,501	138,512	200,013	70,265
Total Year 6–55	$435,395	$(15,107)	$(176,336)	$243,957	$357,569	$601,520	$178,164
Grand Total						$843,994	$241,500

Notes:

(l.) (i) + (k)

(m.) Deferred acquisition costs (DAC) balance as of end of prior year minus DAC balance as of end of current year.

Glossary

Actuarial Calculation. The periodic expected changes in the net closed block liability (on a generally accepted accounting principles basis), which is after the elimination of the effect of applicable items of other comprehensive income. The amortization of deferred acquisition costs is not a component of the actuarial calculation because deferred acquisition costs are not a closed block asset.

Actuarial Calculation Date. The date as of which the actuarial calculation is performed, which is as of the date of demutualization or formation of a mutual insurance holding company (MIHC) or, if not practicable for insurance enterprises that demutualized or formed an MIHC prior to January 1, 2001, as of the beginning of the year of adoption of this Statement of Position.

Carrying Amount. The amount of an item as displayed in the financial statements.

Closed Block. A mechanism to preserve (over time) the reasonable dividend expectations of individual policyholders with individual life, health, or annuity policies for which dividends are currently being paid or are expected to be paid under the current dividend scale. A closed block comprises a defined, limited group of policies and a defined set of assets, and is governed by a set of operating rules.

Date of Demutualization. The date the plan of reorganization becomes effective.

Deferred Acquisition Costs (DAC). Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts (for example, agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees).

Demutualization. The conversion of a mutual insurance enterprise to a stock insurance enterprise.

Dividend Scales. The actuarial formulas used by life insurance companies to determine amounts payable as dividends on participating policies based on experience factors relating, among other things, to investment results, mortality, **lapse rates**, expenses, premium taxes and policy loan interest.

Fair and Equitable. The term *fair and equitable* is generally the terminology used in the demutualization or mutual insurance holding company state regulation to describe how the allocation of consideration to eligible policyholders should be determined.

In Force. Generally, policies and contracts written and recorded on the books of an insurance carrier that are unexpired as of a given date.

Lapse Rate. The rate at which insurance contracts terminate through failure of the insureds to continue required premium payments. The lapse rate may also be considered a rate of *non-persistence.* It is usually expressed as a ratio of the number of contracts that terminated by reason of failure of insureds to make premium payments during a given period, to the total number of contracts at the beginning of the period from which those lapses occurred.

Mortality. The relative incidence of death in a given time or place.

Net Closed Block Liability. The carrying amount of closed block liabilities in excess of the carrying amount of closed block assets each adjusted to eliminate the impact of related amounts in accumulated other comprehensive income at the actuarial calculation date. Deferred acquisition costs are not assets of the closed block.

Nonparticipating Insurance Contracts. Insurance contracts that are not entitled to dividends. Usually issued by a stock life insurance entity at premium rates that are usually lower than those charged where dividends are payable. Mutual entities may issue nonparticipating contracts.

Participating Insurance Contracts. Insurance in which the contractholder is entitled to share in the entity's earnings through dividends that reflect the difference between premium charged and the actual experience.

Persistency. Percentage of life insurance policies or annuity contracts remaining in force between measurement dates.

Plan of Demutualization. The plan of reorganization (including all exhibits and schedules thereto), as it may be amended from time to time, which is adopted by the board of directors of the demutualizing company, pursuant to which the company demutualizes.

Policy Credits. Additional values applied to a policy through dividends, increases in fund values, accumulation values or accumulation account values or extensions of coverages.

Statutory. An other comprehensive basis of accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance enterprise is required to follow when submitting its financial statements to state insurance departments.

Appendix V

Statement of Position 01-3

Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law

June 15, 2001

Issued by the
Accounting Standards Executive Committee

NOTICE TO READERS

This Statement of Position represents the recommendations of the AICPA's Reporting on Internal Control Over Derivative Transactions at Insurance Entities Task Force regarding the application of Statements on Standards for Attestation Engagements to agreed-upon procedures engagements performed to comply with the requirements of Section 1410(b)(5) of the New York State Insurance Law, as amended (the Law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the Law, and Section 178.6(b) of Regulation No. 163. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be aware that they may have to justify departures from the recommendations in this Statement of Position if the quality of their work is questioned.

TABLE OF CONTENTS

Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law

Introduction and Background

1. The New York State Insurance Department (the Department) has issued regulations to implement the New York Derivative Law (the Law) which amends Article 14 of the State of New York Insurance Law, effective July 1, 1999. The Law establishes certain requirements for domestic life insurers, domestic property and casualty insurers, domestic reciprocal insurers, domestic mortgage guaranty insurers, domestic cooperative property and casualty insurance corporations, and domestic financial guaranty insurers. Foreign insurers engaging in derivative transactions and derivative instruments are subject to and required to comply with all of the provisions of the Law. However, a foreign insurer may enter into other derivative transactions provided the insurer meets certain conditions of its domestic state law. In this document, an insurer covered by the Law is referred to as an *insurance company*.

2. The requirements of the Law include the following:

- Approval by the board of directors, or a similar body, of derivative transactions
- Submission of a derivative use plan (the DUP) to the Department
- Assessment by an independent certified public accountant (CPA) of the insurance company's internal control over derivative transactions.

3. In addition to the Law, the Department also has established Regulation No. 163, "Derivative Transactions" (11 NYCRR 178) (the Regulation), which provides guidance in implementing the Law. Section 178.6(b) of Regulation No. 163 states the following.

> As set forth in section 1410(b)(5) of the Insurance Law, an insurer engaging in derivative transactions shall be required to include, as part of the evaluation of accounting procedures and internal controls required to be filed pursuant to section 307 of the Insurance Law, a statement describing the assessment by the independent certified public accountant of the internal controls relative to derivative transactions. The purpose of this part of the evaluation is to assess the adequacy of the internal controls relative to the derivative transactions. Such an assessment shall be made whether or not the derivative transactions are material in relation to the insurer's financial statements and shall report all material deficiencies in internal control relative to derivative transactions, whether or not such deficiencies would lead to an otherwise "reportable condition," as that term is used in auditing standards adhered to by certified public accountants. The statement describing the assessment need not be set forth in a separate report.

4. The Department has proposed that the Regulation be amended to provide that an assessment in the form of an agreed-upon procedures engagement or other attestation engagement, as those terms are used in standards adhered to by CPAs, may be used to meet the requirement for an assessment of internal control over derivative transactions. This proposed amendment to the Regulation has not been promulgated at the date of this Statement of Position (SOP). However, in a letter dated April 27, 2001, the Department stated the following:

> This letter confirms that in determining compliance with Section 1410(b)(5) of the Insurance Law, the Department acknowledges that an agreed-upon procedures engagement, including an engagement performed using the procedures in the proposed SOP ("Performing Agreed-Upon Procedures Engagements that Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law"), can be used to satisfy the statutory requirement.

5. The DUP was due to be filed by applicable insurance companies by January 1, 2000. The first independent CPA's report is due on June 1, 2001. The Law expires on June 30, 2003; however, the State of New York may extend the expiration date.

6. As previously stated, the letter from the Department indicates that an agreed-upon procedures engagement or other attestation engagement may be used to satisfy the requirements of the Law. However, this SOP only describes an agreed-upon procedures engagement. It does not address any other attestation engagements that might be performed, such as an examination-level attestation engagement. For guidance on performing such other attestation engagements, see "Attest Engagements," in Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Codification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101).

Applicability

7. This SOP was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address an insurance company's internal control over derivative transactions to meet the requirements of the Law. Practitioners should note that the engagement described in this SOP is designed only to satisfy the requirements of the Law. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement.

8. Although the Department has indicated that an agreed-upon procedures engagement pursuant to this SOP can be used to satisfy the requirements for an assessment of internal control over derivative transactions, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes.

The Law

Definition of a Derivative

9. Article 14 of the Law defines a derivative instrument as including caps, collars, floors, forwards, futures, options, swaps, swaptions, and warrants.

10. The following definitions are included in the Law and are applicable when performing the agreed-upon procedures engagement described in this SOP.

> *Cap*—An agreement obligating the seller to make payments to the buyer with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price.

Collar—An agreement to receive payments as the buyer of an option, cap, or floor and to make payments as the seller of a different option, cap, or floor.

Floor—An agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, level, performance, or value of one or more underlying interests.

Forward—An agreement (other than a future) to make or take delivery in the future of one or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance, or value of such underlying interests, but shall not mean or include spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions.

Future—An agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of one or more underlying interests.

Option—An agreement giving the buyer the right to buy or receive (a *call option*), sell or deliver (a *put option*), enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, spread, level, performance, or value of one or more underlying interests.

Swap—An agreement to exchange or to net payments at one or more times based on the actual or expected price, yield, level, performance, or value of one or more underlying interests.

Swaption—An option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option.

Warrant—An instrument that gives the holder the right to purchase or sell the underlying interest at a given price and time or at a series of prices and times outlined in the warrant agreement.

11. Article 14 of the Law permits an insurance company to enter into *replication transactions* provided that certain conditions set forth in the Law are met. A replication transaction is defined in the Law as follows.

> A derivative transaction or combination of derivative transactions effected either separately or in conjunction with cash market investments included in the insurer's investment portfolio in order to replicate the investment characteristic of another authorized transaction, investment or instrument and/or operate as a substitute for cash market transactions. A derivative transaction entered into by the insurer as a hedging transaction or income generation transaction authorized pursuant to this section [of the Law] shall not be considered a replication transaction.

Derivative Use Plan

12. An insurance company entering into derivative transactions must file a DUP with the Department. The DUP generally should include the following items:[1]

- A certified copy of the authorization by the insurer's board of directors, or other similar body, to file the DUP, which should include authorization of derivative transactions and an assurance that individuals responsible for derivative transactions, processes, and controls have the necessary experience and knowledge

[1] Reference should be made to the Law and the Regulation for specific details and exact requirements.

- A section on management oversight standards including a discussion of the following:
  - Limits on identified risks
  - Controls over the nature and amount of identified risks
  - Processes for identifying such risks
  - Processes for documenting, monitoring, and reporting risk exposure
  - Internal audit and review processes that ensure integrity of the overall risk management process
  - Quarterly reporting to the board of directors
  - The establishment of risk tolerance levels
  - Management's measurement and monitoring against those levels
- A section on internal control and reporting including a discussion of the following:
  - The existence of controls over the valuation and effectiveness of derivative instruments
  - Credit risk management
  - The adequacy of professional personnel
  - Technical expertise and systems
  - Management reporting
  - The review and legal enforceability of derivative contracts between parties
- A section on documentation and reporting requirements which shall for each derivative transaction document the following:
  - The purpose of the transaction
  - The assets or liabilities to which the transaction relates
  - The specific derivative instrument used
  - For over-the-counter (OTC) transactions, the name of the counterparty and counterparty exposure amount
  - For exchange traded transactions, the name of the exchange and the name of the firm handling the trade
- Written guidelines to be followed in engaging in derivative transactions. The guidelines should include or address the following:
  - The type, maturity, and diversification of derivative instruments
  - The limitation on counterparty exposures, including limitations based on credit ratings
  - The limitations on the use of derivatives
  - Asset and liability management practices with respect to derivative transactions
  - The liquidity needs and the insurance company's capital and surplus as it relates to the DUP
  - The policy objectives of management specific enough to outline permissible derivative strategies
  - The relationship of the strategies to the insurer's operations
  - How the strategies relate to the insurer's risk
  - A requirement that management establish and execute management oversight standards as required by the Law

  - — A requirement that management establish and execute internal control and reporting standards as required by the Law
  - — A requirement that management establish and execute documentation and reporting standards as required by the Law

- Guidelines for the insurer's determination of acceptable levels of basis risk, credit risk, foreign currency risk, interest rate risk, market risk, operational risk, and option risk
- A requirement that the board of directors and senior management comply with risk oversight functions and adhere to laws, rules, regulations, prescribed practices, or ethical standards

Related Professional Standards

AT Section 201, "Agreed-Upon Procedures Engagements," Statement on Standards for Attestation Engagements No. 10

13. Agreed-upon procedures engagements performed to meet the requirements of the Law are to be performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements*, in SSAE No. 10. As described in AT section 201.03, an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of AT section 201 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of AT section 201.

14. AT section 201.06 states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, ". . . (*c*) the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and (*d*) the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes."

15. As previously stated, the letter from the Department states that an agreed-upon procedures engagement may be used to meet the requirement for an independent CPA's assessment of internal control over derivative transactions, and acknowledges the use of this SOP in such engagements. Accordingly, practitioners should not eliminate any of the procedures presented in appendix B, "Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions", of this SOP or reduce the extent of the tests. The Department or the insurance company may request that additional procedures be performed and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

16. As previously noted, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes. *Therefore, the Department should not be named as a specified party to the agreed-upon procedures report, and the use of a practitioner's agreed-upon procedures report, issued in accordance with this SOP, should be restricted to the board of directors and management of the insurance company*. Although the Department is not a specified party, footnote 15 of AT section 101, *Attest Engagements*, states the following, in part:

> . . . a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party.

Statement on Auditing Standards No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

17. Statement on Auditing Standards (SAS) No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance to auditors in planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities in a financial statement audit performed in accordance with generally accepted auditing standards. A practitioner performing the agreed-upon procedures engagement described in this SOP may find it helpful to consider the guidance in SAS No. 92 and the related audit guide of the same name supporting SAS No. 92. Specifically, the practitioner should consider AU sections 332.05 and 332.06 of SAS No. 92 which describe the need for special skill or knowledge to plan and perform the auditing procedures presented in SAS No. 92. That same skill and knowledge is needed to perform the procedures described in this SOP.

18. The procedures in this SOP are not designed to meet the requirements of generally accepted auditing standards for an audit of the financial statements of an entity that engages in derivative transactions. In addition, performing the audit procedures described in SAS No. 92 would not meet the requirements of this SOP.

19. In an audit of financial statements, the auditor may determine that he or she will not perform procedures related to derivative transactions because they are not material to the financial statements. There is no requirement to perform the procedures described in this SOP when performing an audit of financial statements. In contrast, the Law requires that an assessment of internal control be performed whether or not the derivative transactions are material to the insurer's financial statements. Accordingly, a decision not to perform procedures related to derivative transactions in an audit of financial statements, because of immateriality, would not alleviate the requirement to perform the agreed-upon procedures engagement described herein.

Procedures to Be Performed

20. The agreed-upon procedures to be performed are directed toward tests of controls over derivative transactions that occurred during the period covered by the practitioner's report. Any projection of the practitioner's findings to the future is subject to the risk that because of change, the controls may no longer be in existence, suitably designed, or operating effectively. Also, the potential effectiveness of controls over derivative transactions is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected.

21. The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B. The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The findings for each procedure should be reported as *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular insurance company, the procedure should be marked N/A rather than deleted from the report.

22. Section 1 of appendix B of this SOP is applicable to all insurance companies that enter into derivative transactions. Therefore, the procedures in section 1 are to be performed in all engagements performed in accordance with this SOP. Sections 2 through 10 of appendix B of this SOP each address a specific type of derivative. The procedures in those sections are to be performed only if the insurance company entered into derivative transactions of the type covered by the section. Sections that address types of derivatives not used by the insurance company should not be attached to the agreed-upon procedures report.

23. If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section "Description of Exceptions If Any," at the end of each section. The practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner's report, the practitioner's explanation of the exception may include that information; for example, "Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management's assertion."

24. A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

25. The Law requires the insurance company to provide the Department with a statement describing the independent CPA's assessment of the insurance company's internal control over derivative transactions. It also requires the insurance company to include a description of any remedial actions taken or proposed to be taken to correct any deficiencies identified by the independent CPA.

26. AT section 201.40 states the following.

> The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertion related thereto) referred to in the practitioner's report, the practitioner should include this matter in his or her report. For example, if during the course of applying agreed-upon procedures regarding an entity's internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedures, the practitioner should include this matter in his or her report.

27. A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B of this SOP. However, if information indicating a weakness in internal control over derivative transactions comes to the practitioner's attention by other means, such information should be included in the practitioner's report. This would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner's report but prior to the date of the practitioner's report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

Establishing an Understanding With the Client

28. In accordance with AT section 201.10, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the Law. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written communication with the client (an *engagement letter*). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of Section 1410(b)(5) of the Law
- A statement identifying the procedures to be performed as those set forth in this SOP
- A statement identifying the client as the specified party to the agreed-upon procedures report
- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP
- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions, and that if an examination were performed, other matters might come to the practitioner's attention
- A statement indicating that the practitioner will not express an opinion or any other form of assurance
- A statement describing the client's responsibility to comply with the Law and the client's responsibility for the design and operation of effective internal control over derivative transactions
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client
- A statement describing any arrangements to involve a specialist

Management Representations

29. Although AT section 201 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, it is recommended that the practitioner obtain such a letter when performing the engagement described in this SOP. The representation letter generally should be signed by the appropriate members of management including the highest ranking officer responsible for internal control over derivative transactions. Management's refusal to furnish written representations that the practitioner has determined to be appropriate for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement.

30. The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, the practitioner ordinarily would obtain the following representations from management:

- A statement acknowledging responsibility for establishing and maintaining effective internal control over derivative transactions
- A statement that there have been no errors or fraud that might indicate a weakness in the internal control over derivative transactions
- A statement that management has disclosed to the practitioner all significant deficiencies in the design or operation of the internal control over derivative transactions
- A statement that management has disclosed to the practitioner any communications from regulatory agencies, internal auditors, and other practitioners or consultants relating to the internal control over derivative transactions
- A statement that management has made available to the practitioner all information they believe is relevant to the internal control over derivative transactions
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require adjustment to or modification to responses to the agreed-upon procedures

31. An illustrative representation letter is presented in appendix C, "Illustrative Management Representation Letter" of this SOP. For additional information regarding management's representations in an agreed-upon procedures engagement, see AT sections 201.37–.39.

Restriction on the Performance of Procedures

32. As previously stated, a practitioner should not agree to do either of the following.

a. Eliminate any of the procedures presented in appendix B of this SOP, unless a section is not applicable because the insurance company did not enter into derivative transactions addressed by the section.

b. Reduce the extent of the tests in an applicable section.

33. If circumstances impose restrictions on the performance of the agreed-upon procedures presented in appendix B of this SOP, the practitioner should describe the restriction(s) in his or her report or withdraw from the engagement.

Dating the Report

34. The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Effective Date

35. This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that address internal control over derivative transactions required by the Law.

APPENDIX A

Illustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in AT section 201, *Agreed-Upon Procedures Engagements*, in Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 201).

Independent Accountant's Report
on Applying Agreed-Upon Procedures

To the Management of ABC Insurance Company:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP), 01-3, *Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by ABC Insurance Company, solely to assist you in complying with the requirements of Section 1410(b)(5) of the New York State Insurance Law, as amended (the Law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the Law, and Section 178.6(b) of Regulation No. 163 during the year ended December 31, 20XX. Management of ABC Insurance Company is responsible for maintaining effective internal control over derivative transactions. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of ABC Insurance Company. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions of ABC Insurance Company for the year ended December 31, 20XX. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the management and Board of Directors of ABC Insurance Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

APPENDIX B

Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions

The following table lists the types of derivative transactions permitted by the New York Derivative Law (the Law). We inquired of management of the insurance company as to whether the insurance company used the type of derivative addressed by each section, and marked the column entitled "Is the Section Applicable?" either *Yes* or *No* based on management's response to the inquiry. For each type of derivative with a *Yes* response, we performed the procedures in the applicable section and attached the section to the report. For each type of derivative with a *No* response, we did not perform procedures nor did we attach the applicable section to the report. We compared the types of derivative reported by the insurance company in its "Schedule of Derivative Transactions" included in the Annual Statement with the types of derivatives listed in the following table and found that the types of derivatives included in the schedule were marked *Yes* in the table.

Attachments to the Report

No.	**Section of the Agreed-Upon Procedures** *Type of Derivative*	**Is the Section Applicable?** *Yes or No*
1	All Derivative Types	Yes
2	Cap Contracts	
3	Collar Contracts	
4	Floor Contracts	
5	Forward Contracts	
6	Future Contracts	
7	Option Contracts	
8	Swap Contracts	
9	Swaption Contracts	
10	Warrant Contracts	

Section 1—All Derivative Types

Procedures	*No Exception*	*Exception*	*N/A*
The following procedures were performed to test controls applicable to all derivative transactions. The procedures were applied to the internal control over derivative transactions in existence during the year ended December 31, 20XX.			
Documentation of Controls, Policies, and Procedures			
1. Read the insurance company's derivative use plan (DUP), amendments thereto, and its documentation of controls, policies, and procedures that describe internal control over derivative transactions and found that the DUP and the documentation of controls, policies, and procedures include a description of controls that address the following:			
a. Systems or processes for the periodic valuation of derivative transactions including mechanisms for compensating for any lack of independence in valuing derivative positions (Valuation)	_____	_____	_____
b. Systems or processes for determining whether a derivative instrument used for hedging or replication has been effective (Effectiveness)	_____	_____	_____
c. Credit risk management systems or processes for over-the-counter (OTC) derivative transactions that measure credit risk exposure using the counterparty exposure amount and policies for the establishment of collateral arrangements with counterparties (Credit Risk Management)	_____	_____	_____
d. Management assessment of the adequacy and technical expertise of personnel associated with derivative transactions and systems to implement and control investment practices involving derivatives (Professional Competence)	_____	_____	_____
e. Systems or processes for regular reports to management, segregation of duties, and internal review procedures (Reporting)	_____	_____	_____

Procedures	*Findings*		
	No Exception	***Exception***	***N/A***
f. Procedures for conducting initial and ongoing legal reviews of derivative transactions including assessments of contract enforceability (Legal Reviews)			
Nontransaction-Specific Procedures			
2. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the DUP and any amendments thereto.			
3. Inquired of management as to whether the DUP and any amendments thereto were approved by the New York State Insurance Department and was advised that the DUP and any amendments thereto were approved.			
4. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the commitment of financial resources determined by management to be sufficient to accomplish the objectives of the insurance company's DUP.			
This procedure does not provide an assessment of or assurance about the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the DUP.			
In performing the following procedures, the practitioner should be aware that management frequently will have designated and will have in place limits, controls, or procedures that are more restrictive than those approved for use in the DUP.			
5. For the year ended December 31, 20XX, inquired of management and was advised that—			
a. There was monitoring of derivative transactions by a control staff, such as internal audit or other internal review group, that is independent of derivatives trading activities.			

Procedures	*Findings* No Exception	Exception	N/A
b. There were procedures in place for derivative personnel to obtain, prior to exceeding limits prescribed by management, at least oral approval from members of senior management who are independent of derivatives trading activities.	______	______	______
c. There were procedures in place for senior management to address excesses related to management-established limits and divergences from management-approved derivative strategies, and that such management has authority to grant exceptions to derivatives limits.	______	______	______
d. There were procedures in place requiring that management be informed when limits prescribed in the DUP were exceeded and for management to approve corrective action(s) in such circumstances.	______	______	______
e. There were procedures in place for the accurate transmittal of derivatives positions to the risk measurement systems when management had implemented risk management systems.	______	______	______
f. There were procedures in place for the performance of appropriate reconciliations to ensure data integrity across the full range of derivatives, including any new or existing derivatives that may be monitored apart from the main processing networks.	______	______	______
g. There were procedures in place for risk managers and senior management to define constraints on derivative activities to ensure compliance with the DUP and to justify excesses with respect to specified management limits.	______	______	______
h. There were procedures in place for senior management, an independent group, or an individual that management designated to perform at least an annual assessment of the identified controls and financial results of the derivative activities to determine that controls were effectively implemented and that the insurance company's business objectives and strategies were achieved.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
i. There were procedures in place for a review of limits in the context of changes in strategy, risk tolerance of the insurance company, and market conditions.	______	______	______

Reporting to the Board of Directors or Committee Thereof

The Law contains provisions regarding management oversight of derivative and replication transactions.

Procedures	No Exception	Exception	N/A
6. Read the minutes of the board of directors meetings or committees thereof and found an indication that the board of directors or committee thereof received, at least quarterly, a report regarding derivative and replication transactions.	______	______	______
7. Read one quarterly report referred to in procedure 6 and found that the report contained—			
a. A list, or appropriate summaries, of the following:			
(1) Derivative transactions during the period	______	______	______
(2) Derivative transactions outstanding at the end of the period	______	______	______
(3) Unrealized gains or losses on open derivative positions	______	______	______
(4) Derivative transactions closed during the period	______	______	______
b. A summary of the performance of the derivatives in comparison to the objective of the derivative transactions	______	______	______
c. An evaluation of the risks and benefits of the derivative transactions	______	______	______
d. A summary of the amount, type, and performance of replication transactions	______	______	______
8. If the report referred to in the preceding procedure was received, reviewed, and approved by a committee of the board of directors, read the minutes of the board of directors meeting and found an indication that a report of such committee was reviewed at the next board of directors meeting.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
9. Read the board of directors minutes and found an indication that the board of directors received a report during the year describing the level of knowledge and experience of individuals conducting, monitoring, controlling, and auditing derivative and replication transactions.	______	______	______

Derivative and Replication Limitations

The Law contains limits on hedging and replication transactions. An insurance company may enter into hedging or replication transactions if, as a result of and after giving effect to the transaction, the derivative investments and replication investments do not exceed certain specified percentages of admitted assets. The following procedures were performed using one analysis per quarter prepared by the insurance company to monitor compliance with the limitations.

	No Exception	Exception	N/A
10. Obtained and read the insurance company's analysis used to test limitations on investments in derivatives and replication transactions and found that the amounts shown in the analysis indicated that—			
a. The aggregate statement value of options, swaptions, caps, floors, and warrants purchased was not in excess of seven and one-half percent of the insurance company's admitted assets, per the last annual statement.	______	______	______
b. The aggregate statement value of options, swaptions, caps, and floors written was not in excess of three percent of admitted assets.	______	______	______
c. The aggregate potential exposure of collars, swaps, forwards, and futures entered into and options, swaptions, caps, and floors written was not in excess of six and one-half percent of admitted assets.	______	______	______
d. The aggregate statement value of all assets being replicated did not exceed ten percent of the insurance company's admitted assets.	______	______	______

Procedures	*No Exception*	*Exception*	*N/A*
e. The extent of derivative transactions did not exceed the insurance company's internal limitations or that any excess had been specifically authorized by management.			
11. Inquired of the preparer of the analysis read in procedure 10 and was advised that the analysis excluded transactions entered into to hedge the currency risk of investments denominated in a currency other than United States dollars.			
12. Obtained and read the insurance company's analysis used to test limitations on counterparty exposure, as defined in section 178.3(e) of the Regulation, and found that the report indicated that—			
a. The counterparty exposure under one or more derivative transactions for any single counterparty, other than a "qualified counterparty," was not in excess of one percent of the insurance company's admitted assets.			
b. The counterparty exposure under one or more derivative transactions for all counterparties, other than qualified counterparties, was not in excess of three percent of the insurance company's admitted assets.			
13. If the insurance company required collateral arrangements with the counterparties, obtained and read the insurance company's analysis used to monitor the adequacy of the collateral held in accordance with the terms of the arrangement and found that the amount of the collateral held as shown on the analysis was equal to or in excess of the amount to be held.			

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 2—Cap Contracts

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
Performed the following procedures on selected cap contracts to test internal control over cap transactions. Selected five percent of each type of cap transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlings of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into cap contracts.	______	______	______
2. For each cap selected for testing, read management's documentation describing the intended use of the cap and performed the following procedures, as applicable.	______	______	______
For caps used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	______	______	______
b. How the hedge was consistent with the overall risk management strategy	______	______	______
c. How the cap was expected to be effective in offsetting the exposure	______	______	______
d. The approach in assessing the effectiveness of the hedge	______	______	______
4. Determined that the following items were documented:			
a. The purpose(s) of the cap as a hedge	______	______	______

Procedures	*Findings* No Exception	*Exception*	*N/A*
b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount	____	____	____
c. The assets or liabilities (or portion thereof) that the cap hedged	____	____	____
d. Evidence that the cap continued to be an effective hedge	____	____	____
e. Evidence that the cap was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	____	____	____
If the cap was an exact offset to an outstanding cap—			
5. Read documentation indicating that the cap offset an outstanding cap previously purchased or sold by the insurance company and that the cap was an exact offset of the market risk of the cap being offset.	____	____	____
For caps used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	____	____	____
b. How the replication was consistent with the overall management investment strategy	____	____	____
c. How the cap was expected to be effective in replicating the investment characteristics of the replicated investment	____	____	____
d. The approach for assessing the effectiveness of the replication transaction	____	____	____
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	____	____	____

Procedures	*Findings* No Exception	Exception	N/A
b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount	______	______	______
For all selected caps including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize cap transactions. Compared the name of the individual who authorized the cap transaction with the names on the list and found the name of the individual on the list.	______	______	______
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	______	______	______
10. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the cap transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	______	______	______
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade cap contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the cap with the names on the list and found the name of the individual on the list.	______	______	______
13. Obtained a list of individuals authorized to approve payments relating to caps. Compared the name of the individual who approved any payment relating to the cap with the names on the list and found the name of the individual on the list.	______	______	______
14. Compared the name of the individual who approved any payment relating to the cap with the name of the individual who approved entering into the contract and found that the names were different.	______	______	______
15. Compared the name of the individual who received cash or other consideration in connection with the cap with the name of the individual who entered into the contract and found that the names of the individuals were different.	______	______	______
16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the cap and found that the purchase, sale, or closeout was confirmed by the counterparty.	______	______	______
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade caps and found that the name was not on the list.	______	______	______
18. Compared the terms of the cap contract, as stated on the deal ticket and confirmation, with the terms of the cap contract recorded in the insurance company's accounting records and found them to be in agreement.	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
19. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company determined that its accounting records for caps tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	______	______	______
20. Obtained the accounting record documenting modifications, if any, to the cap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	______	______	______
21. Compared the terms of the cap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the cap agreement and found them to be in agreement.	______	______	______
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the cap agreements.	______	______	______
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the cap agreement with the names of individuals authorized to execute purchases, sales, or closeouts of cap contracts and found that the name of the individual was not on the list.	______	______	______
24. Compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
25. If the cap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	______	______	______
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the cap tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	______	______	______
Effectiveness of Caps Used As Hedges and in Replication Transactions			
27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the cap as a hedge or replication in accordance with the policies regarding effectiveness.	______	______	______
28. If the cap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	______	______	______
Legal Review			
29. Read documentation indicating that the legal department reviewed the cap agreement to assess contract compliance with the DUP and enforceability.	______	______	______
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
Valuation			
31. Obtained the insurance company's policies and procedures for valuing caps and found that the insurance company determined the fair value of the cap in accordance with the policy described in the insurance company's procedures for the valuation of caps.	______	______	______
32. Read documentation supporting the fair value of the cap and found that the fair value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized person.	______	______	______

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 3—Collar Contracts

Procedures	*Findings* — *No Exception*	*Exception*	*N/A*
Performed the following procedures on selected collar contracts to test internal control over collar transactions. Selected five percent of each type of collar transaction (that is, executions [entering into a collar transaction in which the net position at inception may result in either no cash outlay, cash received, or cash disbursed] and closeouts [closings and settlings of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into collar contracts.	______	______	______
2. For each collar selected for testing, read management's documentation describing the intended use of the collar and performed the following procedures, as applicable.	______	______	______
For collars used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	______	______	______
b. How the hedge was consistent with the overall risk management strategy	______	______	______
c. How the collar was expected to be effective in offsetting the exposure	______	______	______
d. The approach in assessing the effectiveness of the hedge	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the collar as a hedge	______	______	______
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	______	______	______
c. The assets or liabilities (or portion thereof) that the collar hedged	______	______	______
d. Evidence that the collar continued to be an effective hedge	______	______	______
e. Evidence that the contract was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	______	______	______
If the collar was an exact offset of an outstanding collar—			
5. Read documentation indicating that the collar offset an outstanding collar previously purchased or sold by the insurance company and that the collar was an exact offset of the market risk of the collar being offset.	______	______	______
For collars used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	______	______	______
b. How the replication was consistent with the overall management investment strategy	______	______	______
c. How the collar was expected to be effective in replicating the investment characteristics of the replicated investment	______	______	______
d. The approach in assessing the effectiveness of the replication transaction	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	______	______	______
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	______	______	______
For all selected collars including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize collar transactions. Compared the name of the individual who authorized the collar transaction with the names on the list and found the name of the individual on the list.	______	______	______
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	______	______	______
10. Obtained a list of *qualified* and *nonqualified* counterparties approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the collar transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	______	______	______
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade collar contracts. Compared the name of the individual who executed the execution or closeout of the collar contract with the names on the list and found the name of the individual on the list.	______	______	______
13. Obtained a list of individuals authorized to approve payments relating to collars. Compared the name of the individual who approved any payment relating to the collar with the names on the list and found the name of the individual on the list.	______	______	______
14. Compared the name of the individual who approved any payment relating to the collar with the name of the individual who approved entering into the contract and found that the names were different.	______	______	______
15. Compared the name of the individual who received cash or other consideration in connection with the collar with the name of the individual who entered into the contract and found that the names of the individuals were different.	______	______	______
16. Obtained the deal ticket and confirmation for the execution or closeout of the collar and found that the execution or closeout was confirmed by the counterparty.	______	______	______
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade collars and found that the name was not on the list.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
18. Compared the terms of the collar contract, as stated on the deal ticket and confirmation, with the terms of the collar contract recorded in the insurance company's accounting records and found them to be in agreement.	______	______	______
19. Obtained documentation for one reporting period (for example, monthly or quarterly) indicating that the insurance company determined that its accounting records for collars, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	______	______	______
20. Obtained the accounting record documenting modifications, if any, to the collar agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	______	______	______
21. Compared the terms of the collar agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the collar agreement and found them to be in agreement.	______	______	______
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the collar agreement.	______	______	______
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the collar contracts with the names of individuals authorized to enter into trades, executions, or closeouts of collar contracts and found that the name of the individual was not on the list.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
24. Compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	______	______	______
25. If the collar should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	______	______	______
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the collar tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	______	______	______

Effectiveness of Collars Used As Hedges and in Replication Transactions

27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the collar as a hedge or replication in accordance with the policies regarding effectiveness.	______	______	______
28. If the collar was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
Legal Review			
29. Read documentation indicating that the legal department reviewed the collar agreement to assess contract compliance with the DUP and enforceability.	______	______	______
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	______	______	______
Valuation			
31. Obtained the insurance company's policies and procedures for valuing collars and found that the insurance company determined the fair value of the collar in accordance with the policy described in the insurance company's procedures for the valuation of collars.	______	______	______
32. Read documentation supporting the fair value of the collar and found that the fair value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized individual.	______	______	______

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 4—Floor Contracts

Procedures	*Findings* No Exception	Exception	N/A
Performed the following procedures on selected floor contracts to test internal control over floor transactions. Selected five percent of each type of floor transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlings of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into floor contracts.	____	____	____
2. For each floor selected for testing, read management's documentation describing the intended use of the floor and performed the following procedures, as applicable.	____	____	____
For floors used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	____	____	____
b. How the hedge was consistent with the overall risk management strategy	____	____	____
c. How the floor was expected to be effective in offsetting the exposure	____	____	____
d. The approach in assessing the effectiveness of the hedge	____	____	____

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the floor as a hedge	____	____	____
b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount	____	____	____
c. The assets or liabilities (or portion therof) that the floor hedged	____	____	____
d. Evidence that the floor continued to be an effective hedge	____	____	____
e. Evidence that the floor was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying	____	____	____
If the floor was an exact offset of an outstanding floor—			
5. Read documentation indicating that the floor offset an outstanding floor previously purchased or sold by the insurance company and that the floor was an exact offset of the market risk of the floor being offset.			
For floors used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	____	____	____
b. How the replication was consistent with the overall management investment strategy	____	____	____
c. How the floor was expected to be effective in replicating the investment characteristics of the replicated investment	____	____	____
d. The approach in assessing the effectiveness of the replication transaction	____	____	____

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	______	______	______
b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount	______	______	______
For all selected floors including those that are a part of a replication transaction—			
8. Obtained a list of individuals approved by the board of directors or a committee thereof who had the authority to authorize floor transactions. Compared the name of the individual who authorized the floor transaction with the names on the list and found the name of the individual on the list.	______	______	______
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	______	______	______
10. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the floor transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	______	______	______
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade floor contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the floor with the names on the list and found the name of the individual on the list.	______	______	______
13. Obtained a list of individuals authorized to approve payments relating to floors. Compared the name of the individual who approved any payment relating to the floor with the names on the list and found the name of the individual on the list.	______	______	______
14. Compared the name of the individual who approved any payment relating to the floor with the name of the individual who approved entering into the contract and found that the names were different.	______	______	______
15. Compared the name of the individual who received cash or other consideration in connection with the floor with the name of the individual who entered into the contract and found that the names of the individuals were different.	______	______	______
16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the floor and found that the purchase, sale, or closeout was confirmed by the counterparty.	______	______	______
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade floors and found that the name was not on the list.	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
18. Compared the terms of the floor contract, as stated on the deal ticket and confirmation, with the terms of the floor contract recorded in the insurance company's accounting records and found them to be in agreement.	______	______	______
19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined that its accounting records for floors, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	______	______	______
20. Obtained the accounting record documenting modifications, if any, to the floor agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	______	______	______
21. Compared the terms of the floor agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the floor agreement and found them to be in agreement.	______	______	______
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the floor agreements.	______	______	______
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the floor agreement with the names of individuals authorized to execute purchases, sales, or closeouts of floor contracts and found that the name was not on the list.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
24. Compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	______	______	______
25. If the floor should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	______	______	______
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the floor tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	______	______	______
Effectiveness of Floors Used As Hedges and in Replication Transactions			
27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the floor as a hedge or replication in accordance with the policies regarding effectiveness.	______	______	______
28. If the floor was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
Legal Review			
29. Read documentation indicating that the legal department reviewed the floor agreement to assess contract compliance with the DUP and enforceability.	______	______	______
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	______	______	______
Valuation			
31. Obtained the insurance company's policies and procedures for valuing floors and found that the insurance company determined the fair value of the floor in accordance with the policy described in the insurance company's procedures for the valuation of floors.	______	______	______
32. Read documentation supporting the fair value of the floor and found that the fair value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized individual.	______	______	______

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 5—Forward Contracts

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
Performed the following procedures on selected forward contracts to test internal control over forward transactions. Selected five percent of each type of forward transaction, with the selections distributed throughout the year. These are, (1) forward contracts entered into to make delivery, (2) forward contracts entered into to take delivery, (3) forward contracts settled by making delivery, (4) forward contracts settled by taking delivery, (5) forward contracts settled by cash. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into forward contracts.	______	______	______
2. For each forward selected for testing, read management's documentation describing the intended use of the forward and performed the following procedures, as applicable.	______	______	______
For forward contracts used as a hedge—			
3. Determined that the documentation describes the following:			
a. The risk hedged	______	______	______
b. How the hedge was consistent with the overall risk management strategy	______	______	______
c. How the forward was expected to be effective in offsetting the exposure	______	______	______
d. The approach in assessing the effectiveness of the hedge	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the forward as a hedge	______	______	______
b. The terms of the forward, the name of the counterparty, and the counterparty exposure amount	______	______	______
c. The assets or liabilities (or portion thereof) that the forward hedged	______	______	______
d. The specific forward contract used in the hedge	______	______	______
e. Evidence that the forward continued to be an effective hedge	______	______	______
f. Evidence that the forward was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	______	______	______
If the forward was an exact offset of an outstanding forward—			
5. Read documentation indicating that the forward offset an outstanding forward previously purchased or sold by the insurance company and that the forward was an exact offset of the market risk of the forward being offset.	______	______	______
For forwards used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	______	______	______
b. How the replication was consistent with the overall management investment strategy	______	______	______

Procedures	Findings: No Exception	Exception	N/A
c. How the forward was expected to be effective in replicating the investment characteristic of the replicated investment	______	______	______
d. The approach for assessing the effectiveness of the replication transaction	______	______	______
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	______	______	______
b. The terms of the forward contract, the name of the counterparty, and the counterparty exposure amount	______	______	______
For all selected forwards, including those that are a part of the replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize forward transactions. Compared the name of the individual who authorized the forward transaction with the names on the list and found the name of the individual on the list.	______	______	______
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	______	______	______

Procedures	*Findings*: No Exception	Exception	N/A
10. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the forward transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	______	______	______
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	______	______	______
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade forward contracts. Compared the name of the individual who executed the purchase or sale of the forward with the names on the list and found the name of the individual on the list.	______	______	______
13. Obtained a list of individuals authorized to approve settlements or payments related to forward contracts. For the purchase and any transaction subsequent to purchase, compared the name of the individual who approved any payment or settlement of funds in connection with the forward contract with the names on the list and found the name of the individual on the list.	______	______	______
14. Compared the name of the individual who approved any settlement or payment relating to the forward with the name of the individual who approved entering into the contract and found that the names were different.	______	______	______
15. Compared the name of the individual who received cash or other consideration in connection with the forward with the name of the individual who entered into the contract and found that the names of the individuals were different.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
16. Obtained the deal ticket and confirmation for the purchase or sale of the forward contract and found that the purchase or sale was confirmed by the counterparty.	______	______	______
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade forwards and found that the name was not on the list.	______	______	______
18. Compared the terms of the forward contract, as stated on the deal ticket and confirmation, with the terms of the forward contract recorded in the insurance company's accounting records and found them to be in agreement.	______	______	______
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for forwards, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	______	______	______
20. Obtained the accounting record documenting modifications, if any, to the forward contract. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	______	______	______
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the forward contract and found that the insurance company either (*a*) obtained a statement from the custodian confirming the existence of the forward contract, (*b*) physically inventoried the forward contract, or (*c*) obtained a statement from the counterparty acknowledging the existence of the forward contract.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the forward with the names of individuals authorized to execute purchases and sales of forwards and found that the name was not on the list.	______	______	______
23. Compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	______	______	______
24. If the forward should have been included in the monitoring analysis separately tested in step 10 within section 1, "All Derivative Types," compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	______	______	______
Effectiveness of Forward Contracts Used As Hedges and in Replication Transactions			
25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the forward as a hedge or replication in accordance with the policies regarding effectiveness.	______	______	______
26. If the forward was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
Legal Review			
27. Read documentation indicating that the legal department reviewed the forward contract to assess contract compliance with the DUP and enforceability.			
28. Read documentation indicating that the legal department updated its assessment of contract enforceability at least annually.			
Valuation			
29. Obtained the insurance company's policies and procedures for valuing forwards and found that the insurance company determined the fair value of the forward in accordance with the policy described in the insurance company's procedures for valuation of forwards.			
30. Read documentation supporting the fair value of the forward contract and found that the fair value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized individual.			

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 6—Futures Contracts

Procedures	*Findings*		
	No Exception	*Exception*	*N/A*
Performed the following procedures on selected futures contracts to test internal control over futures transactions. Selected five percent of each type of futures transaction, with the selections distributed throughout the year. These are purchases, sales, and cash settlements (closeouts of a position). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade futures.			
2. For each futures transaction selected for testing, read management's documentation describing the intended use of the futures and performed the following procedures, as applicable.			
For futures used as a hedge—			
3. Determined that the documentation describes the following:			
a. The risk hedged			
b. How the hedge was consistent with the overall risk management strategy			
c. How the futures position was expected to be effective in offsetting the exposure			
d. The approach in assessing the effectiveness of the hedge			

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the futures as a hedge	______	______	______
b. The terms of the futures transaction and the name of the exchange and firm(s) handling the trade	______	______	______
c. The assets or liabilities (or portion thereof) that the futures transaction hedged	______	______	______
d. Evidence that the futures contract continued to be an effective hedge	______	______	______
e. Evidence that the futures position was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for futures transactions; for example, the notional amount or underlying	______	______	______
For futures transactions that were an exact offset of an outstanding futures transaction—			
5. Read documentation indicating that the futures transaction offset an outstanding futures position previously purchased or sold by the insurer and that the futures transaction was an exact offset of the market risk of the futures position being offset.	______	______	______
For futures used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	______	______	______
b. How the replication was consistent with the overall management investment strategy	______	______	______
c. How the futures position was expected to be effective in replicating the investment characteristics of the replicated investment	______	______	______
d. The approach in assessing the effectiveness of the replication transaction	______	______	______

Procedures	*Findings*		
	No Exception	*Exception*	*N/A*
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	______	______	______
b. The terms of the futures transaction and the name of the exchange and the firm(s) handling the trade	______	______	______
c. The specific futures contract used in the replication	______	______	______
For all selected futures including those that are a part of the replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize futures trades. Compared the name of the individual who authorized the futures transaction with the names on the list and found the name of the individual on the list.	______	______	______
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	______	______	______
10. Obtained a list of individuals authorized by the board of directors or committee thereof to trade futures contracts. Compared the name of the individual who executed the purchase or sale of the futures contract with the names on the list and found the name of the individual on the list.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
11. Obtained a list of individuals authorized to approve settlements or disbursements related to futures transactions. For purchases and transactions subsequent to purchase or sale of the futures contract, compared the name of the individual who approved any settlement of funds relating to the futures with the names on the list and found the name of the individual on the list.	______	______	______
12. Compared the name of the individual who approved any payment relating to the futures with the name of the individual who approved entering into the contract and found that the names were different.	______	______	______
13. Compared the name of the individual who received cash or other consideration in connection with the futures with the name of the individual who entered into the contract and found that the names of the individuals were different.	______	______	______
14. Obtained the deal ticket and confirmation for the purchase, expiration, or sale of the futures contracts and found that the purchase, sale, or expiration of the futures contract was confirmed by the deal ticket and confirmation.	______	______	______
15. Compared the terms of the futures transaction, as stated on the deal ticket and confirmation, with the terms of the transaction recorded in the insurance company's accounting records and found them to be in agreement.	______	______	______
16. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for futures, tested in procedure 15, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
17. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the futures contracts and found that the insurance company obtained statements from the futures counterparty(ies) or broker(s) confirming the futures transactions and positions.	______	______	______
18. Compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	______	______	______
19. If the futures position should have been included in the monitoring analysis separately tested in procedure 10 within section 1, " All Derivative Types," compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	______	______	______
Effectiveness of Futures Used As Hedges and in Replication Transactions			
20. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the futures position as a hedge or replication in accordance with the policies regarding effectiveness.	______	______	______
21. If the futures position was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the company policies and procedures and found that the action taken was consistent with the accounting policy.	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
Valuation			
22. Obtained the insurance company's policies and procedures for valuing positions and found that the insurance company determined the valuation of the futures contract in accordance with the policy described in the insurance company's procedures for valuation of futures.	______	______	______
23. Read documentation supporting the market price of the futures contract and found that the market price was obtained from an independent source.	______	______	______

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 7—Option Contracts

Procedures	*Findings* No Exception	Exception	N/A
Performed the following procedures on selected option contracts to test internal control over option transactions. Selected five percent of each type of option transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into option contracts.	______	______	______
2. For each option selected for testing, read management's documentation describing the intended use of the option and performed the following procedures, as applicable.	______	______	______
For options used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	______	______	______
b. How the hedge was consistent with the overall risk management strategy	______	______	______
c. How the option was expected to be effective in offsetting the exposure	______	______	______
d. The approach in assessing the effectiveness of the hedge	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the option as a hedge	____	____	____
b. For over-the-counter (OTC) options, the terms of the option, the name of the counterparty, and the counterparty exposure amount	____	____	____
c. For exchange-traded options, the term of the option, the name of the exchange, and the name of the firm(s) handling the trade	____	____	____
d. The assets or liabilities (or portion thereof) that the option hedged	____	____	____
e. For OTC and exchange-traded options, the specific option used in the hedge	____	____	____
f. Evidence that the option continued to be an effective hedge	____	____	____
g. Evidence that the option was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount, or underlying	____	____	____
If the option transaction was (*a*) for income generation and was for the sale of a call option on securities or (*b*) an exact offset to an outstanding option—			
5. Read the documentation supporting the transaction which indicated that the insurance company was holding or could immediately acquire through the exercise of options, warrants, or conversion rights already owned, the underlying securities during the entire period the option was outstanding.	____	____	____
6. Read documentation indicating that the option offset an outstanding option previously purchased or sold by the insurance company and that the option was an exact offset to the market risk of the option being offset.	____	____	____

Procedures	*Findings* No Exception	Exception	N/A
For options used in a replication transaction—			
7. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	____	____	____
b. How the replication was consistent with the overall management investment strategy	____	____	____
c. How the option was expected to be effective in replicating the investment characteristics of the replicated investment	____	____	____
d. The approach in assessing the effectiveness of the replication transaction	____	____	____
8. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	____	____	____
b. The specific option used in the replication	____	____	____
c. For OTC options, the terms of the option, the name of the counterparty, and the counterparty exposure amount	____	____	____
d. For exchange-traded options, the name of the exchange and the firm(s) handling the trade	____	____	____
For all selected options, including those that are a part of a replication transaction—			
9. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize option transactions. Compared the name of the individual who authorized the option transaction with the names on the list and found the name of the individual on the list.	____	____	____

Procedures	*Findings* No Exception	*Exception*	*N/A*
10. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	____	____	____
11. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the option transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	____	____	____
12. For OTC options, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 11.	____	____	____
13. Obtained a list of individuals authorized by the board of directors or committee thereof to trade option contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the option with the names on the list and found the name of the individual on the list.	____	____	____
14. Obtained a list of individuals authorized to approve payments relating to options contracts. Compared the name of the individual who approved any payment relating to the option with the names on the list and found the name of the individual on the list.	____	____	____

	Findings		
Procedures	*No Exception*	*Exception*	*N/A*
15. Compared the name of the individual who approved any payment relating to the option with the name of the individual who approved entering into the contract and found that the names were different.			
16. Compared the name of the individual who received cash or other consideration in connection with the option with the name of the individual who entered into the contract and found that the names of the individuals were different.			
17. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of the option and found that the purchase, sale, or exercise of the option was confirmed by the counterparty or firm handling the transaction.			
18. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade options and found that the name was not on the list.			
19. Compared the terms of the option contract, as stated on the deal ticket and confirmation, with the terms of the option contract recorded in the insurance company's accounting records and found them to be in agreement.			
20. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company determined whether its accounting records for options, tested in procedure 19, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).			
21. Obtained the accounting record documenting modifications, if any, to the option transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.			

Procedures	*Findings* No Exception	Exception	N/A
22. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company obtained a statement from the counterparty confirming the existence of the option position.	____	____	____
23. Using the list of authorized traders obtained in procedure 13, compared the name of the individual who had custody of or access to the option documentation with the names of individuals authorized to purchase, sell, or exercise the option and found that the name was not on the list.	____	____	____
24. Compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	____	____	____
25. If the option should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	____	____	____
Effectiveness of Options Used As Hedges and in Replication Transactions			
26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the option as a hedge or replication in accordance with the policies regarding effectiveness.	____	____	____
27. If the option was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	____	____	____

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
Legal Review			
28. Read documentation indicating that the legal department reviewed the option agreement to assess contract compliance with the DUP and enforceability.	______	______	______
29. Read documentation indicating that the legal department updated its assessment of legal enforceability of the OTC option agreement at least annually.	______	______	______
Valuation			
30. Obtained the insurance company's policies and procedures for valuing options and found that the insurance company determined the fair value of OTC options and the market price of exchange-traded options, in accordance with the policy described in the insurance company's procedures for the valuation of options.	______	______	______
31. Read documentation supporting the fair value for OTC options and the market price of exchange-traded options and found that the fair value or market value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized individual.	______	______	______

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 8—Swap Contracts

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
Performed the following procedures on selected swap contracts to test internal control over swap transactions. Selected five percent of each type of swap transaction (that is, executions [purchases] and closeouts [sales]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in fewer than four items, selected four or fewer items that represented all the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into swap agreements.	______	______	______
2. For each swap agreement selected for testing, read management's documentation describing the intended use of the swap agreement and performed the following procedures, as applicable.	______	______	______
For swaps used as a hedge—			
3. Determined that the documentation describes the following:			
a. The risk hedged	______	______	______
b. How the hedge was consistent with the overall risk management strategy	______	______	______
c. How the swap was expected to be effective in offsetting the exposure	______	______	______
d. The approach in assessing the effectiveness of the hedge	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the swap as a hedge	______	______	______
b. The terms of the swap, the name of the counterparty, and the counterparty exposure amount	______	______	______
c. The assets or liabilities (or portion thereof) that the swap hedged	______	______	______
d. Evidence that the swap continued to be an effective hedge	______	______	______
e. Evidence that the swap was consistent with the insurance company's parameters, as specified in the DUP or applicable policies and procedures, for entering into swap agreements; for example, the notional amount or underlying	______	______	______
For swaps that were an *exact offset* of an outstanding swap—			
5. Read documentation that indicated that the swap offset a swap previously purchased or sold, and that the swap was an exact offset to the market risk of the swap being offset.	______	______	______
For swaps used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	______	______	______
b. How the replication was consistent with the overall management investment strategy	______	______	______
c. How the swap was expected to be effective in replicating the investment characteristic of the replicated investment	______	______	______
d. The approach in assessing the effectiveness of the replication transaction	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	____	____	____
b. The terms of the swap, the name of the counterparty, and the counterparty exposure amount	____	____	____
For all selected swaps including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize swap transactions. Compared the name of the individual who authorized the swap transaction with the names on the list and found the name of the individual on the list.	____	____	____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	____	____	____
10. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swap agreement with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	____	____	____

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	______	______	______
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swap contracts. Compared the name of the individual who executed the swap with the names on the list and found the name of the individual on the list.	______	______	______
13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaps. For purchases and any interim settlements or closeouts of the swap subsequent to purchase, compared the name of the individual who approved any settlement of funds relating to the swap with the names on the list and found the name of the individual on the list.	______	______	______
14. Compared the name of the individual who approved any payment relating to the swap with the name of the individual who approved entering into the contract and found that the names were different.	______	______	______
15. Compared the name of the individual who received cash or other consideration in connection with the swap with the name of the individual who entered into the contract and found that the names of the individuals were different.	______	______	______
16. Obtained the deal ticket and confirmation for the purchase, execution, or closeout of the swap and found that the purchase, execution, or closeout of the swap was confirmed by the counterparty.	______	______	______
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaps and found that the name was not on the list.	______	______	______

Procedures	*Findings* — *No Exception*	*Exception*	*N/A*
18. Compared the terms of the swap contract, as stated on the deal ticket and confirmation, with the terms of the swap contract recorded in the insurance company's accounting records and found them to be in agreement.			
19. Obtained documentation for one reporting period (for example, monthly, or quarterly), that the insurance company determined whether its accounting records for swaps, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).			
20. Obtained the accounting record documenting modifications, if any, to the swap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.			
21. Compared the terms of the swap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swap agreement and found them to be in agreement.			
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swap agreement with the names of individuals authorized to execute swap agreements and found that the name was not on the list.			
23. Compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.			

Procedures	Findings: No Exception	Findings: Exception	Findings: N/A
24. If the swap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.			
25. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to swap transactions, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.			
Effectiveness of Swaps Used As Hedges and in Replication Transactions			
26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swap as a hedge or replication in accordance with the policies regarding effectiveness.			
27. If the swap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.			
Legal Review			
28. Read documentation indicating that the legal department reviewed the swap agreement to assess contract compliance with the DUP and enforceability.			
29. Read documentation indicating that the legal department updated its assessment of the enforceability of the swap agreement at least annually.			

Procedures	*Findings* No Exception	Exception	N/A
Valuation			
30. Obtained the insurance company's policies and procedures for valuing swaps and found that the insurance company determined the fair value of the swap in accordance with the policy described in the insurance company's procedures for valuation of swaps.	______	______	______
31. Read documentation supporting the fair value of the swap and found that the fair value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized individual.	______	______	______

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 9—Swaption Contracts

Procedures	*Findings* No Exception	Exception	N/A
Performed the following procedures on selected swaption contracts to test internal control over swaption transactions. Selected five percent of each type of swaption transaction with the selections distributed throughout the year. These are executions (purchases) and closeouts (sales). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to buy or sell swaptions.	______	______	______
2. For each swaption contract selected for testing, read management's documentation describing the intended use of the swaption and performed the following procedures, as applicable.	______	______	______
For swaptions used as a hedge—			
3. Determined that the documentation describes the following:			
a. The risk hedged	______	______	______
b. How the hedge was consistent with the overall risk management strategy	______	______	______
c. How the swaption was expected to be effective in offsetting the exposure	______	______	______
d. The approach in assessing the effectiveness of the hedge	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the swaption as a hedge	______	______	______
b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount	______	______	______
c. The assets or liabilities (or portion thereof) that the swaption hedged	______	______	______
d. Evidence that the swaption continued to be an effective hedge	______	______	______
e. Evidence that the swaption was consistent with the insurance company's parameters, as specified in the DUP or applicable policies and procedures, for entering into swaption agreements; for example, the notional amount or underlying	______	______	______
For swaptions that were an exact offset of an outstanding swaption—			
5. Read documentation indicating that the swaption offset an outstanding swaption and that the swaption was an exact offset of the market risk of the swaption being offset.	______	______	______
For swaptions used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	______	______	______
b. How the replication was consistent with the overall management investment strategy	______	______	______
c. How the swaption was expected to be effective in replicating the investment characteristic of the replicated investment	______	______	______
d. The approach in assessing the effectiveness of the replication transaction	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	______	______	______
b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount	______	______	______
For all selected swaptions including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize swaptions. Compared the name of the individual who authorized the swaption transaction with the names on the list and found the name of the individual on the list.	______	______	______
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	______	______	______
10. Obtained a list of qualified and nonqualified counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swaption transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	______	______	______
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swaption contracts. Compared the name of the individual who executed the swaption with the names on the list and found the name of the individual on the list.	______	______	______
13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaption agreements. Compared the name of the individual who approved settlements and disbursements relating to the swaption with the names on the list and found the name on the list.	______	______	______
14. Compared the name of the individual who approved any payment relating to the swaption with the name of the individual who approved entering into the contract and found that the names were different.	______	______	______
15. Compared the name of the individual who received cash or other consideration in connection with the swaption with the name of the individual who entered into the contract and found that the names of the individuals were different.	______	______	______
16. Obtained the deal ticket and confirmation for the purchase, sale, modification, or closeout of the swaption and found that the purchase, sale, modification, or closeout was confirmed by the counterparty.	______	______	______
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaptions and found that the name was not on the list.	______	______	______

Procedures	*Findings* *No Exception*	*Exception*	*N/A*
18. Compared the terms of the swaption contract, as stated on the deal ticket and confirmation, with the terms of the swaption contract recorded in the insurance company's accounting records and found them to be in agreement.	______	______	______
19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined whether its accounting records for swaptions, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	______	______	______
20. Obtained the accounting record documenting modifications, if any, to the swaption agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	______	______	______
21. Compared the terms of the swaption agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swaption agreement and found them to be in agreement.	______	______	______
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swaption agreement with the names of individuals authorized to execute swaption agreements and found that the name was not on the list.	______	______	______
23. Compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	______	______	______

Procedures	*Findings*		
	No Exception	*Exception*	*N/A*
24. If the swaption should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	______	______	______
Effectiveness of Swaptions Used As Hedges and in Replication Transactions			
25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swaption as a hedge or replication in accordance with the policies regarding effectiveness.	______	______	______
26. If the swaption was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	______	______	______
Legal Review			
27. Read documentation indicating that the legal department reviewed the swaption agreement to assess contract compliance with the DUP and enforceability.	______	______	______
28. Read documentation indicating that the legal department updated its assessment of the enforceability of the swaption agreement at least annually.	______	______	______
Valuation			
29. Obtained the insurance company's policies and procedures for valuing swaptions and found that the insurance company determined the fair value of the swaption in accordance with the policy described in the insurance company's procedures for valuation of swaptions.	______	______	______

Procedures	*Findings*		
	No Exception	*Exception*	*N/A*
30. Read documentation supporting the fair value of the swaption and found that the fair value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized individual.	______	______	______

Description of Exceptions if Any

Procedure Number	*Description of Exception*

Section 10—Warrant Contracts

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
Performed the following procedures on selected warrant contracts to test internal control over warrant transactions. Selected five percent of each type of warrant transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.			
Reporting			
1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into warrant contracts.	______	______	______
2. For each warrant selected for testing, read management's documentation describing the intended use of the warrant and performed the following procedures, as applicable.	______	______	______
For warrants used as a hedge—			
3. Determined that the documentation described the following:			
a. The risk hedged	______	______	______
b. How the hedge was consistent with the overall risk management strategy	______	______	______
c. How the warrant was expected to be effective in offsetting the exposure	______	______	______
d. The approach in assessing the effectiveness of the hedge	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
4. Determined that the following items were documented:			
a. The purpose(s) of the warrant as a hedge	______	______	______
b. For exchange-traded warrants, the term of the warrant, the name of the exchange, and the name of the firm(s) handling the trade	______	______	______
c. For over-the-counter (OTC) warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount	______	______	______
d. The assets or liabilities (or portion thereof) that the warrant hedged	______	______	______
e. Evidence that the warrant continued to be an effective hedge	______	______	______
f. Evidence that the warrant was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying	______	______	______
If the warrant transaction was an exact offset of an outstanding warrant—			
5. Read documentation indicating that the warrant transaction offset an outstanding warrant previously purchased or sold by the insurance company and that the warrant was an exact offset of the market risk of the warrant being offset	______	______	______
For warrants used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	______	______	______
b. How the replication was consistent with the overall management investment strategy	______	______	______

Procedures	*Findings*		
	No Exception	***Exception***	***N/A***
c. How the warrant was expected to be effective in replicating the investment characteristics of the replicated investment	______	______	______
d. The approach in assessing the effectiveness of the replication transaction	______	______	______
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	______	______	______
b. The specific warrant used in the replication	______	______	______
c. For exchange-traded warrants, the name of the exchange and the firm(s) handling the trade	______	______	______
d. For OTC warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount	______	______	______
For all selected warrants including those that are part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize warrant transactions. Compared the name of the individual who authorized the warrant transaction with the names on the list and found the name of the individual on the list.	______	______	______
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support, and found evidence of approval of the transaction tested	______	______	______

Procedures	*Findings*		
	No Exception	*Exception*	*N/A*
10. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the warrant transaction with names on the list, and found the name of the counterparty on the respective qualified or nonqualified list.	____	____	____
11. For OTC warrants, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure, consistent with the classification in the listing obtained in procedure 10.	____	____	____
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade warrant contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the warrant with the names on the list and found the name of the individual on the list.	____	____	____
13. Obtained a list of individuals authorized to approve payments related to warrant contracts. Compared the name of the individual who approved any payment relating to the warrant with the names on the list, and found the name of the individual on the list.	____	____	____
14. Compared the name of the individual who approved any payment relating to the warrant with the name of the individual who approved entering into the contract and found that the names were different.	____	____	____
15. Compared the name of the individual who received cash or other consideration in connection with the warrant with the name of the individual who entered into the contract and found that the names of the individuals were different.	____	____	____

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
16. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of an exchange-traded warrant and found that the purchase, sale, or exercise was confirmed by the firm handling the transaction.	______	______	______
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade warrants and found that the name was not on the list.	______	______	______
18. Compared the terms of the warrant contract, as stated on the deal ticket and confirmation, with the terms of the warrant contract recorded in the insurance company's accounting records and found them to be in agreement.	______	______	______
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined whether its accounting records for warrants, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	______	______	______
20. Obtained the accounting record documenting modifications, if any, to the warrant transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	______	______	______
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the warrant contract and found that the insurance company either (*a*) obtained statements from the custodian confirming the existence of the warrant contracts or (*b*) physically inventoried the warrant contracts.	______	______	______

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody of or access to the warrant contracts with the names of individuals authorized to execute purchases, sales, or exercises of warrants and found that the name was not on the list.	______	______	______
23. Compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	______	______	______
24. If the warrant position should have been included in the monitoring analysis separately tested in procedure10 of section 1,"All Derivative Types," compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	______	______	______
Effectiveness of Warrants Used As Hedges and in Replication Transactions			
25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the warrant as a hedge or replication in accordance with the policies regarding effectiveness.	______	______	______
26. If the warrant was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
Legal Review			
27. Read documentation indicating that the legal department reviewed a nonexchange traded warrant agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
28. Read documentation indicating that the legal department updated its assessment of enforceability of the nonexchange traded warrant agreement at least annually.	_____	_____	_____
Valuation			
29. Obtained the insurance company's policies and procedures for valuing warrants and found that the insurance company determined the fair value of the warrant in accordance with the policy described in the insurance company's procedures for the valuation of warrants	_____	_____	_____
30. Read documentation supporting the fair value of warrants and found that the fair value was either (*a*) obtained from an independent source, (*b*) checked against an independent source, or (*c*) calculated internally by an authorized individual.	_____	_____	_____

Description of Exceptions if Any

Procedure Number	*Description of Exception*

APPENDIX C

Illustrative Management Representation Letter

[Responsible Party's Letterhead]

[Date]

[CPA Firm's Name and Address]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position 01-03, *Performing Agreed-Upon Procedures Engagements that Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by management of ABC Insurance Company, solely to assist us in complying with the requirements of Section 1410(b)(5) of the New York State Insurance Law, as amended (the Law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the Law and Section 178.6 of Regulation No. 163 during the year ended December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for establishing and maintaining effective internal control over derivative transactions in accordance with the Law.
2. During the year ended December 31, 20XX, the internal control over derivative transactions was functioning in accordance with the policies and procedures set forth in the Company's derivative use plan (DUP) and related accounting policies and procedures. There have been no errors or fraud that would indicate a weakness in the internal control over derivative transactions.
3. We have disclosed to you all significant deficiencies in the design or operation of the internal control over derivative transactions that would adversely affect the Company's ability to function in accordance with the Company's DUP.
4. There have been no communications from regulatory agencies, internal auditors, or other practitioners or consultants relating to the internal control over derivative transactions, including communications received between December 31, 20XX and the date of this letter.
5. We have made available to you all information that we believe is relevant to the internal control over derivative transactions.
6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[Signature]

[Title]

[Signature]

[Title]

Appendix W

Statement of Position 01-5

Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification

December 14, 2001

Issued by the
Accounting Standards Executive Committee

NOTICE TO READERS

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the area of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accouning Principles, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This AICPA Statement of Position (SOP) amends AICPA SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, as a result of the completion of the National Association of Insurance Commissioners (NAIC) Codification of statutory accounting practices for certain insurance enterprises.

The amendments to SOP 94-5 included in this SOP require insurance enterprises to disclose, at the date each balance sheet is presented, beginning with financial statements for fiscal years ending on or after December 15, 2001, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices. Retroactive application is not permitted.

Those disclosures should be made if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices, and the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed.

Those disclosures should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.*

This SOP also includes the following auditing guidance that has been updated as a result of the completion of the NAIC Codification: AICPA SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*; SOP 94-1, *Inquiries of State Insurance Regulators*; and AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81). The included auditing guidance has been approved by the Auditing Standards Board.

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* It should be noted that the language of this Statement of Position (SOP) assumes for simplicity that the reporting entity is a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements. Clarification of the disclosure requirements for a foreign insurance enterprise that does not have a U.S. insurance subsidiary and prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, is noted in footnote 1 of paragraph 8 of the amended SOP 94-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*.

This SOP is effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements. If comparative financial statements are presented for fiscal years ending before December 15, 2001, the disclosure provisions of SOP 94-5 effective prior to this SOP apply to permitted statutory accounting practices by the regulatory authority.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a proposed final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft, or after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing a final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.
2. The proposal will result in an improvement in practice.
3. The AICPA demonstrates the need for the proposal.
4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification

Background and Basis for Conclusions

1. In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law.

2. Prescribed statutory accounting practices are practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence.

3. Permitted statutory accounting practices include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) if it wishes to depart from the prescribed statutory accounting practice or (*b*) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

4. The revised Manual is effective for implementation on January 1, 2001, as the foundation for statutory accounting practices. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual.

5. This Statement of Position (SOP) amends the guidance in AICPA SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, for changes related to the NAIC Codification. The amendments to SOP 94-5 included in this SOP require a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements to disclose, at the date each balance sheet is presented, beginning with financial statements for fiscal years ending on or after December 15, 2001, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1] The Accounting Standards Executive Committee (AcSEC) believes that this disclosure is useful because it distinguishes both prescribed and permitted practices of insurers by state, and presents statutory surplus of insurers on a comparable basis. AcSEC is aware that certain insurance enterprises domiciled in Bermuda, the Cayman Islands, and other foreign jurisdictions may prepare financial statements in accordance with accounting principles generally accepted in the United States of America even though such enterprises do not conduct business in the United States. Additionally, a U.S.-based enterprise may have a foreign domiciled insurance subsidiary and a foreign-based enterprise may have a U.S.-domiciled insurance subsidiary. Because foreign insurance operations (whether they are in a foreign subsidiary of a U.S.-based enterprise, the foreign insurance operations of a foreign-based enterprise that has U.S.-domiciled operations or the foreign insurance operations of a foreign-based enterprise that does not have U.S.-domiciled insurance operations) are not subject to the United States regulatory framework, AcSEC does not believe it is appropriate for those enterprises to determine how the NAIC Codification would affect foreign insurance operations. With respect to their foreign insurance operations, those enterprises should disclose a description of and related monetary effect of any permitted regulatory accounting practices granted by their respective regulatory authority. The disclosure requirements need not apply to a foreign parent that files financial statements in accordance with home country GAAP that are reconciled to accounting principles generally accepted in the United States.

6. This SOP also includes the following auditing guidance that has been updated based on the completion of the NAIC Codification: AICPA SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*; AICPA SOP 94-1, *Inquiries of State Insurance Regulators*; and AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81). The included auditing guidance has been approved by the Auditing Standards Board.

7. AcSEC believes it is appropriate to have all accounting and auditing guidance that changes due to the completion of the NAIC Codification in one document, because it is easier for readers to review all relevant changes related to this topic. This SOP includes complete sets of updated accounting and auditing guidance, marked to show additions and deletions for changes related to the NAIC Codification. In April 2001, AcSEC issued for public comment an exposure draft of a proposed SOP, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*. During the forty-five-day comment period, AcSEC received two comment letters.

Amendments to SOP 94-5

8. The following replaces or modifies several paragraphs of SOP 94-5 as a result of the completion of the NAIC Codification. New language is under-

[1] The language of this Statement of Position (SOP) assumes for simplicity that the reporting entity is a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, that prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.

lined; deleted material is in strikethrough. The changes are effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. There are no changes to the original paragraphs 9 and 11; those paragraphs are included here for completeness.

~~**Introduction**~~

~~**.01** Most of the accounting principles related to disclosures for insurance enterprises were promulgated over twenty years ago when the insurance regulatory and business environments were less complex and volatile. Accordingly, the AICPA Accounting Standards Executive Committee (AcSEC) added a project to its agenda to consider whether new disclosures should be required in insurance enterprises' financial statements. This statement of position (SOP) is a result of that project.~~

Scope

.01 ~~**.02**~~ This Statement of Position (SOP) applies to annual and complete sets of interim financial statements prepared in conformity with generally accepted accounting principles (GAAP) of life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. ~~Furthermore, AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60-.79), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements as they do for financial statements prepared in conformity with GAAP.~~

Applicability to Statutory Financial Statements

.02 AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of Statement on Auditing Standards No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81), requires auditors to apply the same disclosure evaluation criteria for statutory financial statements and for financial statements prepared in conformity with GAAP.

Relationship to Other Pronouncements

.03 In some circumstances, the disclosure requirements in this SOP may be similar to, or overlap, the disclosure requirements in certain other authoritative accounting pronouncements issued by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), ~~and~~ or the Securities and Exchange Commission (SEC). For example—

- FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, requires certain disclosures related to loss contingencies, including catastrophe losses of property and casualty insurance companies.
- FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, requires certain disclosures about liabilities for unpaid claims and claim adjustment expenses and statutory capital.
- FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, requires certain disclosures about reinsurance transactions.

- AICPA SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires disclosures about certain significant estimates.
- The SEC Securities Act Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Insurance Underwriters*, requires disclosures of information about liabilities for unpaid claims and claim adjustment expenses.

The disclosure requirements in this SOP supplement the disclosure requirements in other authoritative pronouncements. This SOP does not alter the requirements of any FASB or SEC pronouncement.

Conclusions

.04 The disclosure requirements in this section should be read in conjunction with appendix A, "Illustrative Disclosures," item A-2 [paragraph .15], and appendix B, "Discussion of Conclusions," item B-1 [paragraph .16]. ~~of this SOP.~~

~~Permitted~~ Statutory Accounting Practices

.05 ~~Insurance enterprises currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The National Association of Insurance Commissioners (NAIC) currently has a project under way to codify statutory accounting practices through a complete revision of its *Accounting Practices and Procedures Manuals*, that, when complete, is expected to replace prescribed or permitted statutory accounting practices as the statutory basis of accounting for insurance enterprises (referred to hereafter as the "codification"). Therefore, the codification will likely result in changes to what is currently considered a prescribed statutory accounting practice. Furthermore, postcodification-permitted statutory accounting practices will be exceptions to the statutory basis of accounting.~~ The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*, except as prescribed or permitted by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of insurance enterprises should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

.06 Prescribed ~~precodification~~ statutory accounting practices ~~include~~ are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state~~;~~. ~~*NAIC Annual Statement Instructions*; the *NAIC Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC *Examiners' Handbook*.~~ A state may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

.07 Permitted statutory accounting practices include practices not prescribed by the domiciliary state as described in paragraph .06 above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An ~~I~~insurance enterprises may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of ~~their~~ the enterprise's statutory financial statements (*a*) ~~when the enterprise~~ if it wishes to depart from the prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

.08 The disclosures in this paragraph should be made ~~for permitted statutory accounting practices for the most recent fiscal year presented, regardless of when the permitted statutory accounting practice was initiated~~. if (*a*) state prescribed statutory accounting practices differ from NAIC statutory accounting practices or (*b*) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices. The disclosures should be made if the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed. If an insurance enterprise's risk-based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. Insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed statutory accounting practices or NAIC statutory accounting practices.[1] ~~Insurance enterprises should disclose the following information about permitted statutory accounting practices that individually or in the aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed statutory accounting practices:~~

~~*a.* A description of the permitted statutory accounting practice~~

~~*b.* A statement that the permitted statutory accounting practice differs from prescribed statutory accounting practices~~

~~*c.* The monetary effect on statutory surplus~~

~~Insurance enterprises should disclose the following information about permitted statutory accounting practices, excluding GAAP practices used, when prescribed statutory accounting practices do not address the accounting for the transaction:~~

~~*a.* A description of the transaction and of the permitted statutory accounting practice used~~

~~*b.* A statement that prescribed statutory accounting practices do not address the accounting for the transaction~~

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[1] Disclosures in this paragraph should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. generally accepted accounting principles (GAAP) financial statements. If a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority and their monetary effects.

Liability for Unpaid Claims and Claim Adjustment Expenses

.09 The liability for unpaid claims and claim adjustment expenses represents the amounts needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the statement of financial position date). The estimated liability includes the amount of money that will be required for future payments of (*a*) claims that have been reported to the insurer, (*b*) claims related to insured events that have occurred but that have not been reported to the insurer as of the date the liability is estimated, and (*c*) claim adjustment expenses. Claim adjustment expenses include costs incurred in the claim settlement process such as legal fees; outside adjuster fees; and costs to record, process, and adjust claims.

.10 Financial statements should disclose for each fiscal year for which an income statement is presented the following information about the liability for unpaid claims and claim adjustment expenses:

a. The balance in the liability for unpaid claims and claim adjustment expenses at the beginning and end of each fiscal year presented, and the related amount of reinsurance recoverable

b. Incurred claims and claim adjustment expenses with separate disclosure of the provision for insured events of the current fiscal year and of increases or decreases in the provision for insured events of prior fiscal years

c. Payments of claims and claim adjustment expenses with separate disclosure of payments of claims and claim adjustment expenses attributable to insured events of the current fiscal year and to insured events of prior fiscal years

Also, insurance enterprises should discuss the reasons for the change in ~~the provision for~~ incurred claims and claim adjustment expenses recognized in the income statement attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of the prior-year effects.

.11 In addition to the disclosures required by FASB Statement No. 5 and other accounting pronouncements, insurance enterprises should disclose management's policies and methodologies for estimating the liability for unpaid claims and claim adjustment expenses for difficult-to-estimate liabilities, such as for claims for toxic waste cleanup, asbestos-related illnesses, or other environmental remediation exposures.

Effective Dates and Transition

.12 ~~This~~ The provisions of this SOP as originally issued in 1994 are ~~is~~ effective for annual and complete sets of interim financial statements for periods ending after December 15, 1994. Disclosures of information required by paragraph .10 should be included for each fiscal year for which an income statement is presented.

.13 The provisions of this SOP as amended by AICPA SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, are effective for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. Disclosures of information required by amended paragraph .08 and item A-2 in appendix A [paragraph 15] should be included for each fiscal year for which a balance sheet is presented. In the initial year of implementation of those disclosures, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required by the SOP prior to those amendments. Retroactive application of the amendments is not permitted.

Amendments to SOP 94-5, Appendix A

9. The following is from SOP 94-5, appendix A, "Illustrative Disclosures". There are no changes to the original paragraph A-4. That paragraph is included here for completeness. The changes require insurance enterprises to disclose information per item A-2, for annual financial statements for fiscal years ending on or after December 15, 2001, and complete sets of interim financial statements for periods beginning on or after that date. New language is underlined; deleted material is in strikethrough.

Illustrative Disclosures

A-1. The illustrations included in this appendix are guides to implementation of the disclosures required by this SOP. Insurance enterprises are not required to display the information contained herein in the specific manner or in the degree of detail illustrated. Alternative disclosure presentations are permissible if they satisfy the disclosure requirements of this Statement of Position (SOP).

Prescribed or Permitted Statutory Accounting Practices

A-2. ~~The f~~Following ~~is an~~ are two examples of illustrative~~on of~~ disclosures that an insurance enterprise ~~would~~ could make ~~before the codification is complete~~, to meet the requirements of paragraph .08, item 8, of this SOP.

Note X. ~~Permitted~~ Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by $2.5 million and $2.3 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was $30.0 million and $27.9 million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been $29.9 million and $27.7 million at December 31, 20X2 and 20X1, respectively.

~~Property and Casualty Company, Inc., domiciled in ABC State, prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the ABC State Insurance Department. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed.~~

~~The company received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC state require that loss reserves be discounted at Y percent. As of December 31, 19X3, that permitted transaction increased statutory surplus by $XX million over what it would have been had prescribed accounting practice been followed.~~ [‡]

‡ ~~If an insurance company's risk-based capital (RBC) would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements.~~

Note X. Statutory Accounting Practices

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department. [*State of domicile*] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of the [*state of domicile*] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP.

The monetary effect on statutory capital and surplus of using accounting practices prescribed or permitted by the [*state of domicile*] Insurance Department is as follows:

	December 31	
	20x2	20x1
	$m	$m
Statutory capital and surplus per statutory financial statements	$30.0	$27.9
Effect of permitted practice of recording home office property at estimated fair value	(2.5)	(2.3)
Effect of [*state of domicile's*] prescribed practice of immediate write-off of goodwill[1]	2.4	2.1
Statutory capital and surplus in accordance with the NAIC statutory accounting practices[2]	$29.9	$27.7

1 This amount compared to the prior year reflects the net impact of an additional year's amortization and the fact that admitted goodwill is based on the level of statutory capital and surplus and thus can fluctuate.

2 In the initial year of implementation of this disclosure, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required under the original SOP.

Liability for Unpaid Claims and Claim Adjustment Expenses

A-3. The following is an illustration of information an insurance enterprise would disclose to meet the requirements of paragraph .10 of this SOP. (This illustration presents amounts incurred and paid net of reinsurance. The information may also be presented before the effects of reinsurance with separate analysis of reinsurance recoveries and recoverables related to the incurred and paid amounts.)

Note X. Liability for Unpaid Claims and Claim Adjustment Expenses

Activity in the liability for unpaid claims and claim adjustment expenses is summarized as follows.

	~~19X5~~ 20X2	~~19X4~~ 20X1
Balance at January 1	$7,030	$6,687
Less reinsurance recoverables	1,234	987
Net Balance at January 1	5,796	5,700
Incurred related to:		
Current year	2,700	2,600
Prior years	(171)	96
Total incurred	2,529	2,696
Paid related to:		
Current year	781	800
Prior years	2,000	1,800
Total paid	2,781	2,600
Net Balance at December 31	5,544	5,796
Plus reinsurance recoverables	1,255	1,234
Balance at December 31	$6,799	$7,030

As a result of changes in estimates of insured events in prior years, the ~~provision of~~ claims and claim adjustment expenses (net of reinsurance recoveries of $X and $X in ~~19X5~~20X2 and ~~19X4~~20X1, respectively) decreased by $171 million in ~~19X5~~20X2 ~~because of~~ reflecting lower-than-anticipated losses on Hurricane Howard, and increased by $96 million in ~~19X4~~20X1 ~~because of~~ reflecting higher-than-anticipated losses and related expenses for claims for asbestos-related illnesses, toxic waste cleanup, and workers' compensation.

A-4. The following is an illustration of an insurance enterprise disclosure designed to meet the requirements of paragraph .11 of this SOP. (Additional disclosures about the liabilities for unpaid claims and claim adjustment expenses may be required under FASB Statement No. 5, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, AICPA SOP 94-6, and SEC requirements.)

Note X. Environmental-Related Claims

In establishing the liability for unpaid claims and claim adjustment expenses related to asbestos-related illnesses and toxic waste cleanup, management considers facts currently known and the current state of the law and coverage litigation. Liabilities are recognized for known claims (including the cost of related litigation) when sufficient information has been developed to indicate the involvement of a specific insurance policy, and management can reasonably estimate its liability. In addition, liabilities have been established to cover additional exposures on both known and unasserted claims. Estimates of the liabilities are reviewed and updated continually. Developed case law and adequate claim history do not exist for such claims, especially because significant uncertainty exists about the outcome of coverage litigation and whether past claim experience will be representative of future claim experience.

Amendments to SOP 94-5, Appendix B

10. The following is from SOP 94-5, appendix B, "Discussion of Conclusions," when the SOP was originally issued in 1994. Sections B-1, B-4, B-5, B-6, B-7, and B-14 have been revised as a result of the completion of the NAIC Codification. The remaining sections are included for background information about prior AcSEC discussions. New language is underlined; deleted material is in strikethrough.

Discussion of Conclusions

B-1. In 1999, the National Association of Insurance Commissioners (NAIC) completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. This SOP was updated in 2001 to conform to the revised Manual. This section discusses factors that were deemed significant by members of the Accounting Standards Executive Committee (AcSEC) in reaching the conclusions in this SOP when it was originally issued in 1994. It includes reasons for accepting certain views and rejecting others. Individual AcSEC members gave greater weight to some factors than to others.

B-2. The business and regulatory environment of insurance enterprises has become more complex and volatile, and therefore riskier. Accordingly, AcSEC believed the need existed to reconsider the disclosures made in the financial statements of insurance enterprises.

B-3. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, states financial reporting should "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). Further, the Concepts Statement says that to support that decision-making process, financial reports should help such users "assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprises" (paragraph 37) by providing "information about the economic resources of an enterprise, the claims to those resources. . . and the effects of transactions, events, and circumstances that change resources and claims to those resources" (paragraph 40).

B-4. AcSEC considered a wide variety of potential disclosures, and tried to identify the areas of importance to insurance enterprises for which the current disclosures were lacking. AcSEC concluded that additional disclosures in the financial statements of insurance enterprises about regulatory risk-based capital, the liability for unpaid claims, and certain accounting methods permitted by state ~~insurance departments~~ regulatory authorities would help insurance enterprises better meet the objectives of financial reporting in their financial statements. After the completion of the NAIC codification, AcSEC concluded that additional disclosures reconciling statutory surplus between statutory financial statements (including permitted practices), state prescribed basis, and in accordance with NAIC statutory accounting practices would be useful to the reader of generally accepted accounting principles (GAAP) financial statements. AcSEC is aware that certain insurance enterprises domiciled in Bermuda, the Cayman Islands, and other foreign jurisdictions may prepare financial statements in accordance with accounting principles generally accepted in the United States even though such enterprises do not conduct business in the United States. Additionally, a U.S.-based enterprise may have a foreign-domiciled insurance subsidiary and a foreign-based enterprise may have a U.S.-domiciled insurance subsidiary. Because the foreign insurance operations of such enterprises (whether they are in a foreign subsidiary of a U.S.-based enterprise, the foreign insurance operations of a foreign-based enterprise that has U.S.-domiciled operations or the foreign insurance operations of a foreign-based enterprise that does not have U.S.-domiciled insurance operations) are not subject to the United States regulatory framework, AcSEC does not believe it is appropriate for those enterprises to determine how the NAIC codification would affect foreign insurance operations. With respect to their foreign insurance operations, those enterprises should disclose a description of and related monetary effect of any permitted regulatory accounting practices granted by their respective regulatory authority. The disclosure requirements need not apply to a foreign parent that files financial statements in accordance with home country GAAP that are reconciled to accounting principles generally accepted in the United States.

Risk-Based Capital

B-5. Insurance enterprises operate in a highly regulated environment directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the insurance system. Historically, regulation of insurance enterprises has monitored solvency by focusing on their capital. One of the primary tools used by state ~~insurance departments~~ regulatory authorities for ensuring that their objectives are being met is risk-based capital (RBC).

B-6. The NAIC has developed an RBC program that is used by state regulatory authorities ~~insurance departments~~ to enable them to take appropriate and timely regulatory actions relating to insurers that show signs of weak or deteriorating financial conditions. This program is encompassed in the RBC Model Acts for life and property and casualty insurers, which have been or are intended to be adopted by most of the states. RBC is a series of dynamic surplus-related formulas set forth in the NAIC's RBC instructions for life and health and for property and casualty insurance enterprises. The formulas contain a variety of weighing factors that are applied to financial balances or to levels of activity based on the perceived degree of certain risks, such as asset risk, credit risk, interest rate risk (life insurance enterprises only), underwriting risk, and other business risks, such as risks related to management, regulatory action, and contingencies. The amount determined under such formulas, the authorized control level risk-based capital, is required to be disclosed in life insurance enterprises' statutory filings starting for the year ended December 31, 1993, and in property and casualty insurance enterprises' statutory filings starting for the year ended December 31, 1994.

B-7. The exposure draft of the SOP that was originally issued in 1994 contained a requirement that insurance enterprises that are required to calculate RBC should disclose in their financial statements the ratio of total adjusted capital to authorized control level RBC and the amount of total adjusted capital for each fiscal year for which a statement of financial position is presented.

B-8. However, the NAIC's RBC Model Acts for both life and property and casualty insurers have a confidentiality provision, which states:

> [E]xcept as otherwise required under the provisions of this Act [that is, in the annual financial reports filed with state insurance departments], the making, publishing, disseminating, circulation, or placing before the public, or causing, directly or indirectly to be made, placed before the public, in a newspaper, magazine or other publication . . . with regard to the RBC levels of any insurer . . . would be misleading and is therefore prohibited.

B-9. Prior to issuing the exposure draft, based on discussions with the drafters of the RBC Model Acts and some state insurance regulators, and based on the fact that the information is already in the public domain, AcSEC believed that the confidentiality provisions were not intended to apply to disclosures in financial statements. However, a number of respondents to the exposure draft stated that they believe disclosing RBC levels in financial statements would be illegal in states that have enacted the RBC Model Acts. They point out that words in the RBC Model Acts appear to be intended to restrict *all* other disclosure of RBC levels, including in insurers' financial statements.

B-10. AcSEC continues to believe, because of the importance of RBC in the regulatory oversight of insurance enterprises, that its disclosure would improve the relevance and usefulness of insurance enterprises' financial statements, and, therefore, it should be disclosed in the financial statements. Nevertheless, AcSEC concluded the legal issues require further consideration.

B-11. AcSEC decided that this SOP should not be delayed while the legal issues regarding RBC disclosures are considered. A separate SOP on RBC disclosures will be considered at a later date.

B-12. Nevertheless, AcSEC encourages insurance enterprises to disclose RBC levels if they are domiciled in states that have not adopted the RBC Model Acts, or if they have otherwise determined that it is legal to make such disclosures in their financial statements.

B-13. The exposure draft also required insurance enterprises whose level of RBC has triggered a regulatory event[21] to disclose certain information in their financial statements. Delaying the issuance of the RBC guidance does not change the fact that under Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), auditors must consider the need for disclosures about the principal conditions and events that triggered the regulatory event and the possible effects of such conditions and events, as well as management's plans.

[21] Under the NAIC's RBC Model Acts, when the ratio of total adjusted capital to authorized control level RBC is less than or equal to 2 or less than or equal to 2.5 with negative trends for life insurance enterprises, a regulatory event exists—that is, the insurance enterprise would fail to meet the minimum RBC requirements. There are four types of regulatory events, ranging from least to most serious: company action level event, regulatory action level event, authorized control level event, and mandatory control level event.

Permitted Statutory Accounting Practices

B-14. Permitted statutory accounting practices historically have not been disclosed in the notes to the financial statements, except to the extent that they have been disclosed in the accounting practices and procedures note to the statutory financial statements. With increasing frequency, insurance enterprises have transactions that are not explicitly addressed by prescribed accounting practices, or for which no analogous prescribed accounting practices exist. Furthermore, insurance enterprises often request exceptions from certain prescribed accounting practices. Permitted statutory accounting practices may differ from state to state, and from company to company within a state, and may change in the future. Moreover, permitted statutory accounting practices have been used to enhance insurance enterprises' surplus positions. For example, some state ~~insurance departments~~ regulatory authorities have permitted certain insurance enterprises to adjust home office facilities to appraised values even though the states' prescribed statutory accounting practices require that such assets be carried at depreciated historical cost.

B-15. AcSEC believes the required disclosure of permitted statutory accounting practices will enhance the relevance of the financial statements and fulfill the financial reporting objective of providing current and potential investors, creditors, policyholders, and other users of an insurance enterprise's financial statements with useful information. Not only will such disclosures identify situations in which permitted statutory accounting practices enhance an insurance enterprise's statutory capital and RBC position, but they also will improve the comparability of insurance enterprises' financial statements.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-16. Insurance enterprises estimate their liability for unpaid claims and claim adjustment expenses for reported and unreported claims incurred as of the end of the accounting period in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. The liability is estimated based on past loss experience, adjusted for current trends and other factors that will modify past experience. The liability may be calculated using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models.

B-17. FASB Concepts Statement No. 1, paragraph 21, states:

> The information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened. Management may communicate information about its plans or projections, but financial statements and most other financial reporting are historical . . . Estimates resting on expectations of the future are often needed in financial reporting, but their major use, especially of those formally incorporated in financial statements, is to measure financial effects of past transactions or events or the present status of an asset or liability . . . . To provide information about the past as an aid in assessing the future is not to imply that the future can be predicted merely by extrapolating past trends or relationships. Users of the information need to assess the possible or probable impact of factors that may cause change and form their own expectations about the future and its relation to the past.

B-18. AcSEC believes that disclosures about an insurance enterprise's liabilities for unpaid claims and claim adjustment expenses development are useful in understanding the insurance enterprise's liabilities and results of operations. Furthermore, AcSEC notes the disclosures are the same as some of the loss reserve development disclosures that the SEC requires registrants to file with the commission under Securities Act Guide 6.

B-19. Paragraph 60(a) of FASB Statement No. 60~~, *Accounting and Reporting by Insurance Enterprises*~~, requires all insurance enterprises to disclose the basis for estimating the liabilities for unpaid claims and claim adjustment expenses. Furthermore, FASB Statement No. 5, *Accounting for Contingencies*, requires disclosure of loss contingencies not accrued, for which it is at least reasonably possible that a loss has been incurred. Because of the relatively high degree of coverage litigation and the lack of historical information regarding the amount and nature of both known and unasserted claims relating to difficult-to-estimate liabilities (such as those related to environmental related illness claims and toxic-waste cleanup claims), traditional loss reserving techniques may not be used in estimating such liabilities. Therefore, a high degree of judgment is needed in estimating the amount of losses, and practice is developing in the area. Accordingly, AcSEC believes financial statement users will benefit from disclosure of the policies and methods management has used for estimating these amounts.

Discussion of Comments Received on Exposure Draft

B-20. An exposure draft of a~~n~~ S~~s~~tatement of P~~p~~osition (SOP), *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*, was issued on April 20, 1994, and distributed to a variety of interested parties to encourage comment by those that would be affected by the proposal. Forty comment letters were received on the exposure draft.

Risk-Based Capital

B-21. A number of comments were received on the risk-based capital disclosures. As discussed in paragraphs B-5 through B-13, AcSEC decided to consider a separate SOP at a later date on risk-based capital disclosures. The comments will be addressed at that time.

Permitted Statutory Accounting Practices

B-22. A number of respondents to the exposure draft of the SOP requested that the disclosure requirements for permitted statutory accounting practices be postponed until after the codification is complete. AcSEC believes that the disclosures are especially important before codification to improve understanding of the factors that affect comparability among the statutory capital of insurance enterprises.

B-23. Respondents asked for clarification of how disclosure of the monetary effect of statutory surplus would be calculated, particularly when there is no prescribed accounting practice to compare with the permitted practice. AcSEC agreed and revised the exposure draft to state that for permitted statutory accounting practices used when prescribed accounting practice is silent, a description of the transaction is sufficient. Respondents also asked for clarification about whether there should be disclosure of GAAP-permitted practices when there is no prescribed statutory accounting. If an insurance company uses a GAAP practice in its statutory financial statements when there is no prescribed practice, that is still considered a permitted statutory accounting practice. However, AcSEC agreed that no disclosures should be made for GAAP practices that are used when prescribed statutory practices do not specify the accounting for the transaction.

B-24. Respondents suggested that the requirement in the exposure draft to make a statement about the codification be eliminated. AcSEC agreed the disclosure might be confusing to users of financial statements, and eliminated the requirement.

Liability for Unpaid Claims and Claim Adjustment Expenses

B-25. The exposure draft would have required disclosure of information about actuarial adjustments made for nonrecurring or abnormal experience. A number of respondents suggested that that disclosure requirement be eliminated. AcSEC was persuaded that such actuarial adjustments are a normal part of making estimates that should not be disclosed in the financial statements and eliminated the requirement.

Amendments to SOP 95-5

11. The following replaces or modifies several paragraphs of SOP 95-5 as a result of the completion of the NAIC Codification, as well as other conforming changes, including SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), and SAS No. 93, *Omnibus Statement on Auditing Standards—2000* (AICPA, *Professional Standards*, vol. 1, AU secs. 315, 508, and 622). New language is underlined; deleted material is in strikethrough. The changes are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. There are no changes to the original paragraph 23; that paragraph is included here for completeness.

Introduction and Background

.01 All states require domiciled insurance enterprises to submit to the state insurance commissioner an annual statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the annual statements. ~~Currently, s~~Statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the ~~insurance department~~ regulatory authority of the state of domicile," referred to in this Statement of Position (SOP) as ~~*prescribed-or-permitted*~~ *statutory accounting practices*. Statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) as described in Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623).

.02 ~~The NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. When the NAIC completes the codification of statutory accounting practices (the codification), it is expected that the states will require that statutory financial statements be prepared using accounting practices "prescribed in the NAIC's~~ ~~*Accounting Practices and Procedures Manual,*~~~~" referred to in this SOP as~~ ~~*NAIC codified statutory accounting*~~. The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as otherwise prescribed by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

~~**.03** This SOP is intended to apply to audits of statutory financial statements pre- and post-codification. The term statutory basis of accounting is used in this SOP to refer to whatever is accepted as the statutory basis of accounting; currently, that is prescribed-or-permitted statutory accounting. When codification is complete, it is expected that the statutory basis of accounting will be NAIC-codified statutory accounting.~~

Prescribed-or-Permitted Statutory Accounting Practices

.03 ~~**.04**~~ Prescribed statutory accounting practices ~~currently~~ are those practices that are incorporated directly or by reference ~~included~~ in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.~~; t. The NAIC~~ ~~*Annual Statement Instructions*~~~~; the NAIC~~ ~~*Accounting Practices and Procedures Manuals*~~~~; the~~ ~~*Securities Valuation Manual*~~ ~~(published by the NAIC Securities Valuation Office); NAIC official proceedings; and the NAIC~~ ~~*Examiner's Handbook*~~. States may adopt the revised Manual in whole or in part as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

.04 ~~**.05**~~ Permitted statutory accounting practices include practices not prescribed ~~in the sources~~ by the domiciliary state as described in paragraph ~~.04~~ .03, above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An ~~I~~insurance enterprises may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (*a*) ~~when~~ if it wishes to depart from the state prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction~~(s)~~. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

~~NAIC Codified Statutory Accounting~~

~~**.06** The NAIC undertook the project to codify statutory accounting practices because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely—not only from state to state, but for insurance enterprises within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance enterprises. Current statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) under Statement on Auditing Standards (SAS) No. 62, *Special Reports*. When codification is complete, it is anticipated that a statutory basis of accounting for insurance enterprises other than NAIC codified statutory accounting will be considered neither generally accepted accounting principles (GAAP) nor OCBOA.~~[‡] ~~SAS No. 62, paragraphs 27 to 30, provides guidance on reporting on financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA. That guidance is for financial statements prepared in accordance with an agreement (for example, a loan agreement) and that form of report should not be used for statutory financial statements of insurance enterprises.~~

‡ ~~When the codification is complete, certain amendments to SAS No. 62 would be required.~~

Other Relevant AICPA Pronouncements

.05 ~~**.07**~~ During 1994, the AICPA issued the following two pronouncements that address statutory accounting practices and statutory financial statements. These documents were amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*.

a. SOP 94-1, *Inquiries of State Insurance Regulators*, requires, for each audit, auditors to obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the ~~insurance department~~ regulatory authority of the state of domicile.

b. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, requires insurance enterprises to disclose information about prescribed and permitted statutory accounting practices in their financial statements.

Applicability

.06 ~~**.08**~~ This SOP applies to all audits of statutory financial statements of insurance enterprises that file financial statements with state regulatory authorities ~~insurance departments~~, including stock and mutual insurance enterprises. Insurance enterprises that prepare statutory financial statements include life and health insurance enterprises, property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or inter-insurance exchanges, pools, syndicates, captive insurance companies, financial guaranty insurance enterprises, health maintenance organizations, and hospital, medical, and dental service or indemnity corporations.

.07 ~~.09~~ This SOP supersedes SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies*. It also amends the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Life and Health Insurance Entities*. ~~the AICPA Industry Audit Guide Audits of *Stock Life Insurance Companies*.~~[2]

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[2] ~~The AICPA is revising the Audit and Accounting Guide *Audits of Life and Health Insurance Entities*, which will incorporate this SOP.~~

Conclusions

Superseding Statement of Position 90-10, Reports on Audited Financial Statements of Property and Liability Insurance Companies

.08 ~~.10~~ Auditors should not issue reports on statutory financial statements as to fair presentation in conformity with ~~the~~ statutory accounting practices ~~basis of accounting~~ that include a disclaimer of opinion as to fair presentation in conformity with generally accepted accounting principles (GAAP).

General-Use ~~Distribution~~ Reports

.09 ~~.11~~ ~~Under SAS No. 62, i~~If an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject, the auditor of those statements should use the general-use ~~distribution~~ form of report for financial statements that lack conformity with GAAP (SAS No. 62, *Special Reports* [AICPA, *Professional Standards*, vol. 1, AU sec. 623]). ~~Paragraph .04 in~~ SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, "Lack of Conformity With Generally Accepted Accounting Principles," AU sec. 544.04)~~*Lack of Conformity With Generally Accepted Accounting Principles*, (AICPA, *Professional Standards*, vol. 1, AU sec. 544)~~, requires the auditor to use the standard form of report described in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), modified as appropriate because of departures from GAAP.

.10 ~~.12~~ Although it may not be practicable to determine the amount of difference between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance enterprises' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are material and pervasive. ~~Therefore, a~~Auditors should express an adverse opinion with respect to conformity with GAAP ~~(refer to SAS No. 58, paragraph 67)~~, unless the auditor determines the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are not material and pervasive.

.11 ~~.13~~ ~~Paragraphs 68 and 69 in SAS No. 58 requires an~~ The auditor, when expressing an adverse opinion, is required to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (*a*) all of the substantive reasons for the adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable[~~3~~1] (AU sec. 508.59 and .60). If the effects are not reasonably determinable, the report should so state, and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss ~~the~~ statutory accounting practices ~~basis of accounting~~ and describe how those practices differ from GAAP.

.12 ~~.14~~ After expressing an ~~adverse or qualified~~ opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with ~~the~~ statutory accounting practices. ~~basis of accounting under SAS No. 1, section 544. If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, an accounting practice that departs from that basis of accounting, regardless of whether required by state law or permitted by state regulators, would be considered an exception to the statutory basis of accounting. Accordingly~~, If ~~such~~ departures from statutory accounting practices are found to exist and are considered to be ~~are~~ material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508) regarding conformity with GAAP.~~[4]~~

.13 ~~.15~~ Following is an illustration of an independent auditor's report on the general-use ~~distribution statutory~~ financial statements of an insurance enterprise prepared in conformity with ~~prescribed or permitted~~ statutory accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with ~~the~~ statutory accounting practices ~~basis of accounting~~. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and ~~the~~ statutory accounting practices ~~basis of accounting~~ are not reasonably determinable.

~~8~~1 SAS No. 32, *Adequacy of Disclosure in the Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), defines practicable as "the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the auditor's report.

~~4~~ ~~See footnote 1~~.

Independent Auditor's Report

To the Board of Directors
ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, ~~19~~20X2 and ~~19~~20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with ~~generally accepted~~ auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],[5] which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between ~~the~~ statutory accounting practices ~~basis of accounting~~ and ~~generally accepted~~ accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with ~~generally accepted~~ accounting principles generally accepted in the United States of America, the financial position of ABC Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, or the results of its operations or its cash flows for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

5 ~~If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's Accounting Practices and Procedures Manual," or other appropriate language~~.

Limited-Use ~~Distribution~~ Reports

.14 ~~**.16**~~ Prescribed-or-permitted statutory accounting practices for insurance enterprises ~~currently is~~ are considered an OCBOA as described in SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623). If an insurance enterprise's statutory financial statements are intended solely for filing with state regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject, the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. ~~Paragraph .05f of SAS No. 62 recognizes that~~Such reporting is appropriate even though the auditor's report may be made a matter of public record (AU sec. 623.05*f*). However, that paragraph further states that limited-use ~~distribution~~ reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance enterprise is subject. The auditor's report should contain a statement that there is a restriction on ~~distribution~~ the use of the statutory financial statements to those within the insurance enterprise and for filing with the state regulatory authorities ~~insurance departments~~ to whose jurisdiction the insurance enterprise is subject.

.15 ~~**.17**~~ Although auditing standards do not prohibit an auditor from issuing limited-use ~~distribution~~ and general-use ~~distribution~~ reports on the same statutory financial statements of an insurance enterprise, it is preferable to issue only one of those types of reports. Few, if any, insurance enterprises that do not prepare financial statements in ~~accordance~~ conformity with GAAP will be able to fulfill all of their reporting obligations with limited-use ~~distribution~~ statutory financial statements.

.16 ~~.18~~ Following is an illustration, adapted from paragraph 8 of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623.08), of an unqualified auditor's report on limited-use ~~distribution statutory~~ financial statements prepared in conformity with ~~prescribed-or-permitted~~ statutory accounting practices.

Independent Auditor's Report

To the Board of Directors
XYZ Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the related statutory statements of income and changes in surplus, and cash flows, for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with ~~generally accepted~~ auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [*state of domicile*],[6] which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20~~19~~X2 and 20~~19~~X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and the management of XYZ Insurance Company and state insurance departments to whose jurisdiction the company is subject and is not intended to be and should not be used by anyone other than these specified parties.

6 ~~If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's Accounting Practices and Procedures Manual," or other appropriate language~~.

~~.19 In accordance with paragraph 10 of SAS No. 62, the notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discusses the statutory basis of accounting and describes how the basis differs from GAAP. However, the effects of the differences need not be quantified.~~

General-Use and Limited-Use ~~Distribution~~ Reports

.17 The notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discuss statutory accounting practices and describe how this basis differs from GAAP (AU sec. 623.10). In general-use statutory financial statements, the effects of the differences should be disclosed, if quantified. However, in limited-use statutory financial statements, the effects of the differences need not be quantified or disclosed.

.18 ~~.20~~ The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in ~~paragraph 11 of~~ SAS No. 58 (AU sec. 508.11)and ~~paragraph 31 of~~ SAS No. 62 (AU sec. 623.31) regardless of any of the following:

a. The type of report—general-use or limited-use ~~distribution~~

b. The opinion expressed—unqualified, qualified, or adverse

c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory accounting practices ~~basis of accounting~~

For example, in a general-use ~~distribution~~ report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the statutory accounting practices ~~basis of accounting~~, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance enterprise's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

.19 ~~.21~~ ~~As discussed in paragraph 37 of SAS No. 58 and paragraph 31 of SAS No. 62, in a separate paragraph of the auditors report, t~~The auditor may wish to emphasize a matter in a separate paragraph of the auditor's report [AU sections 508.37 and 623.31]. When an insurance enterprise prepares its financial statements using accounting practices prescribed or permitted by the ~~insurance department~~ regulatory authority of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance enterprise's statutory capital,[7] the auditor is strongly encouraged to include an emphasis-of-a-matter paragraph in the report describing the permitted practices and their effects on statutory capital.

~~[7]~~ ~~If, as anticipated, NAIC-codified statutory accounting replaces the prescribed or permitted statutory basis of accounting, such permitted practices would be considered departures from the statutory basis of accounting~~.

.20 ~~.22~~ An example of an emphasis-of-a-matter paragraph follows:

> As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [*state of domicile*] in 20~~19~~XX to write up its home office property to appraised value; under prescribed statutory accounting practices home office property is carried at depreciated cost. As of December 31, 20~~19~~X5, that permitted accounting practice increased statutory surplus by $XX million over what it would have been had the prescribed accounting practices been followed.

.21 If subsequent to the initial adoption of the revised Manual there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph of the report (AU sec. 508.16). The explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer to the note in the financial statements that discusses the change. The auditor's concurrence with a change is implicit, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the statutory accounting practices.

.22 An example of an explanatory paragraph follows:

> As discussed in Note X to the financial statements, the Company changed its method of accounting for guaranty funds and other assessments.

Mutual Life Insurance Enterprises

.23 In April 1993, the Financial Accounting Standards Board (FASB) issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that mutual life insurance enterprises can no longer issue statutory financial statements that are described as "in conformity with generally accepted accounting principles." Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) For statutory financial statements of mutual life insurance enterprises issued before that effective date, auditors may report on the statutory financial statements as being in conformity with generally accepted accounting principles.

Effective Dates

.24 ~~This~~The provisions of this SOP as originally issued in 1995 should be applied to audits of statutory financial statements for years ended on or after December 31, 1996. The amendments to this SOP are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted.

Amendments to SOP 94-1

12. The following replaces or modifies several paragraphs of SOP 94-1 as a result of the completion of the NAIC Codification. New language is underlined; deleted material is in strikethrough. The changes are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. There are no changes to the original paragraphs 1 and 4; those paragraphs are included here for completeness.

Introduction

.01 This S~~s~~tatement of P~~p~~osition (SOP) addresses the auditor's consideration of regulatory examinations as a source of evidential matter in conducting an audit of an insurance enterprise's financial statements and the auditor's evaluation of material permitted statutory accounting practices.

Applicability

.02 This SOP applies to audits of financial statements of life insurance enterprises,[1] property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. It amends chapters 2 ("Audit Considerations") of the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Life and Health Insurance Entities*~~chapter 9 ("Auditing Procedures") of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.~~[2]

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1 FASB Intrepretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, clarifies that FASB Statements and Interpretations and Accounting Principles Board (APB) Opinions apply to mutual life insurance enterprises, except when specifically exempted, that prepare financial statements in conformity with generally accepted accounting principles. This SOP applies to audits of mutual life insurance enterprises.

~~2 The AICPA's Insurance Companies Committee technical agenda includes a project to supersede the Industry Audit Guide Audits of Stock Life Insurance Companies. The new Audit and Accounting Guide Audits of Life and Health Insurance Enterprises will include the guidance contained in this SOP.~~

.03 The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised Manual by the various state regulatory authorities.

Auditor's Consideration of State Regulatory Examinations

.04 ~~**.03**~~ ~~Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, states that t~~The auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies~~.~~" (Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, AICPA, *Professional Standards*, vol. 1, AU sec. 342). ~~SAS No. 54, Illegal Acts by Clients, notes that "t~~The auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the auditor~~.~~" (SAS No. 54, *Illegal Acts by Clients*, AICPA, *Professional Standards*, vol. 1, AU sec. 317). Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance enterprise to obtain competent evidential matter.

.05 ~~**.04**~~ The auditor should review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor should—

- Request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.
- Read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.
- Inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

.06 ~~.05~~ A refusal by management to allow the auditor to review communications from, or to communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion. (~~See~~ SAS No. 58, *Reports on Audited Financial Statements*, (AICPA, *Professional Standards*, vol. 1, AU sec. 508). A refusal by the regulator to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

Auditor's Consideration of Permitted Statutory Accounting Practices

.07 ~~.06~~ Prescribed statutory accounting practices ~~currently include~~ are those practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. ~~; the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions; the NAIC *Accounting Practices and Procedures Manuals*; the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office); NAIC official proceedings; and the *NAIC Examiners' Handbook*~~. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state.

.08 ~~.07~~ Permitted statutory accounting practices include practices not prescribed by the domiciliary state, as described in paragraph ~~.06~~ .07 above, but allowed by the domiciliary state ~~insurance department~~ regulatory authority. An insurance enterprise~~s~~ may request permission from the domiciliary state ~~insurance department~~ regulatory authority to use a specific accounting practice in the preparation of ~~their~~ the enterprise's statutory financial statements (*a*) ~~when the enterprise~~ if it wishes to depart from the prescribed statutory accounting practices, or (*b*) ~~when~~ if prescribed statutory accounting practices do not address the accounting for the transaction~~(s)~~. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

.09 ~~.08~~ Auditors should exercise care in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters.~~[3]~~ For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are ~~material~~ significant to an insurance enterprise's financial statements are permitted by the domiciliary state ~~insurance department~~ regulatory authority.

~~[3] The AICPA has issued an exposure draft of a statement of position, *Disclosures of Certain Matters in Financial Statements of Insurance Enterprises*, that would require insurance enterprises to disclose information about permitted statutory accounting practices in their financial statements prepared in conformity with generally accepted accounting principles~~.

.10 ~~.09~~ Sufficient competent evidential matter consists of any one or combination of—

- Written acknowledgment sent directly from the regulator to the auditor. (This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.)

- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.
- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances.

.11 ~~**.10**~~ If the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor should qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit~~. (See~~ SAS No. 58 [AICPA, *Professional Standards*, vol. 1, AU sec. 508]~~, *Reports on Audited Financial Statements.*~~).

Effective Dates

.12 ~~**.11**~~ ~~This~~The provisions of this SOP as originally issued in 1994 should be applied to audits of financial statements performed for periods ending on or after December 15, 1994. The amendments to this SOP are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted.

Amendments to Interpretation No. 12 of SAS No. 62 [AICPA, *Professional Standards,* vol. 1, AU sec. 9623.60–.81]

13. The following replaces or modifies several paragraphs of Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.81), as a result of the completion of the NAIC Codification. New language is underlined; deleted language is in strikethrough.

Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis

.60 *Question*—Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a "statutory basis") in addition to, or instead of, financial statements prepared in accordance with generally accepted accounting principles (GAAP). Effective January 1, 2001, most states are expected to adopt a comprehensively updated *Accounting Practices and Procedures Manual*, as revised by the National Association of Insurance Commissioners' (NAIC's) Codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised Manual. The revised Manual contains extensive disclosure requirements. As a result, after a state adopts the revised Manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC Annual Statement Instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised Manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?[1]

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[1] It is possible for one of three different situations to occur: The state adopted the revised Manual without significant departures, adopted the revised Manual with significant departures, or has not yet adopted the revised Manual.

.61 *Interpretation*—Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to ~~section 623~~ SAS No. 62, *Special Reports*. ~~Section 623.09~~ SAS No. 62 (AU sec. 623.09) states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting ~~as he or she does~~ as those applied to financial statements prepared in conformity with generally accepted accounting principles. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraph .04.

.62 SAS No. 62 ~~Section~~ (AU sec. 623.02) states that generally accepted auditing standards apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

.63 *Question*—What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

.64 *Interpretation*—~~Section~~ SAS No. 62 (AU sec. 623.09 and .10) indicates that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used~~,~~. That includes ~~including~~ a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. ~~Section~~ SAS No. 62 (AU sec. 623.10) also states that when "the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with generally accepted accounting principles, similar informative disclosures are appropriate."

~~**.65** In addition, in 1991, the National Association of Insurance Commissioners (NAIC) has adopted new Annual Statement instruction, Annual Audited Financial Reports, under which insurance enterprises are required to include in their statutory basis financial statements those disclosures that "are appropriate to a CPA audited financial report, based on applicability, materiality and significance, taking into account the subjects covered in the instructions to and illustrations of how to report information in the notes to the financial statements section of [the] Annual Statement instructions and any other notes required by generally accepted accounting principles. . . ." The laws and regulations of some individual states contain similar requirements.~~

~~.66 Therefore, the auditor should also consider the disclosures and illustrations of how to report information in the notes to financial statements section of the Annual Statement instructions.~~

.65 ~~**.67**~~ *Question*—How does the auditor evaluate whether "similar informative disclosures" are appropriate for—

a. Items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?

b. Items and transactions that are accounted for differently under a statutory basis than under GAAP?

c. Items and transactions that are accounted for differently under requirements of the state of domicile than under the revised Manual?

.66 ~~**.68**~~ *Interpretation*—Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under ~~a~~ the statutory basis as under GAAP should be the same as, or *similar to*, the disclosures required by GAAP unless the revised Manual specifically states the NAIC Codification rejected the GAAP disclosures. Disclosures should also include those required by the revised Manual. ~~Other disclosures considered necessary upon review of the Annual Statement instructions should also be made to the extent that such disclosures are significant to the statutory basis financial statements.~~

~~**.69** For example, disclosures in statutory basis financial statements concerning financial instruments should include the applicable disclosures required by FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises, FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments, and FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities.~~

.67 ~~**.70**~~ Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under ~~a~~ the statutory basis than under GAAP, but in accordance with the revised Manual, should be ~~the same~~ as the disclosures required by the revised Manual. ~~GAAP that are relevant to the statutory basis of accounting for that item. Such disclosures can be separated into two general categories, which are discussed in paragraphs .71–76 of this Interpretation. The examples presented are for illustrative purposes only and are not intended to be all-inclusive.~~

.68 ~~**.71** Specific disclosures are stated in GAAP literature for the accounting method used in the statutory basis financial statements, even though the item would be accounted for differently under GAAP. In such instances, the applicable GAAP disclosures should be made in addition to those disclosures considered necessary upon review of the Annual Statement instructions.~~ If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised Manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made.

~~**.72** For example, certain leases entered into by a lessee insurance enterprise that would be accounted for as capital leases under GAAP are accounted for as operating leases by insurance enterprises in their statutory basis financial statements. In such instances, the applicable disclosures for operating leases required by FASB Statement No. 13, Accounting for Leases, should be made in the statutory basis financial statements.~~

~~.73 Another example is reinsurance transactions. Certain reinsurance contracts are permitted to be accounted for as reinsurance transactions in statutory basis financial statements but would be accounted for as financing transactions under GAAP. In such instances, the applicable disclosures for the contracts accounted for as reinsurance transactions that are required by FASB Statement No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts, should be made in statutory basis financial statements.~~

~~.74 Specific disclosures are not stated in current GAAP literature for the accounting method used in the statutory basis financial statements. If statutory accounting principles (SAP) permit insurance enterprises to use an accounting method that has been superseded under GAAP literature, disclosures that were required under the superseded GAAP literature should be made.~~

~~.75 For example, some insurance companies are permitted to account for pensions in their statutory basis financial statements using the same method as required under APB Opinion No. 8, Accounting for the Cost of Pension Plans, which was amended by FASB Statement No. 36, Disclosure of Pension Information. (APB Opinion No. 8 and FASB Statement No. 36 were superseded by FASB Statement No. 87, Employers' Accounting for Pensions [AC section P16], for fiscal years that began after December 15, 1986.) In addition to disclosing the accounting policy for pensions, insurance companies should make the disclosures contained in APB Opinion No. 8 and FASB Statement No. 36 in their statutory basis financial statements. If a company is accounting for pensions using another method of measurement, such as tax, it should make informative disclosures, at a minimum, such as type of benefit formula, funding policy, fair value of plan assets, and amount of pension costs.~~

~~.76 A final example is deferred acquisition costs (DAC). Acquisition costs are expensed when paid under SAP and are capitalized and amortized under GAAP. FASB Statement No. 60 [AC section In6] requires certain disclosures about DAC—the nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period. Because DAC are not capitalized under SAP, such disclosures, other than a description of the accounting policy used, are unapplicable.~~

.69 ~~.77~~ When evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (*a*) related party transactions, (*b*) restrictions on assets and owners' equity, (*c*) subsequent events, and (*d*) uncertainties. Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

.70 *Question*—There may also be instances in which state requirements have not been revised to reflect a new GAAP disclosure requirement. What are the disclosure requirements in those situations?

.71 *Interpretation*—Until state requirements are determined, the statutory basis financial statements should include disclosures required by new GAAP requirements that are relevant and significant to the statutory basis of accounting, pending acceptance or rejection for inclusion in the revised Manual.

Effective Date and Transition

14. This SOP is effective for annual financial statements for fiscal years ending on or after December 15, 2001, complete sets of interim financial statements for periods beginning on or after that date, and audits of those financial statements. Disclosures of information required by the amendment of SOP 94-5, in paragraph 8, item 8, and paragraph 9, item A-2 of this SOP, should be included for each fiscal year for which a balance sheet is presented. Retroactive application is not permitted. If comparative financial statements are presented for fiscal years ending before December 15, 2001, the disclosure provisions of SOP 94-5, as effective prior to this SOP, apply to permitted statutory accounting practices by the domiciliary state regulatory authority.

Appendix X

Statement of Position 02-1

Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

May 23, 2002

Issued by the
Accounting Standards Executive Committee

NOTICE TO READERS

This Statement of Position (SOP) represents the recommendations of the AICPA's New Jersey Annual Claims Prompt Payment Reports Task Force regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures engagements performed to comply with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), which establishes Department of Banking and Insurance (Department) standards for the payment of claims relating to health benefits plans and dental plans and contains requirements for carriers to file certain reports with the Department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the Department. The Department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the Code. The Auditing Standards Board has found the recommendations in this SOP to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be aware of and consider these recommendations. If the auditor does not apply these recommendations, the auditor should be prepared to explain how he or she complied with the SSAE provisions addressed by these recommendations.

TABLE OF CONTENTS

Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

Introduction and Background

1. New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), establishes Department of Banking and Insurance (Department) standards for the payment of claims relating to health benefits plans and dental plans and contains requirements for carriers to file certain reports with the Department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the Department.

2. NJAC 11:22-1 applies to any insurance company, health service corporation, medical service corporation, hospital service corporation, health maintenance organization, dental service corporation, and dental plan organization that issues health benefits plans or dental plans in the state of New Jersey and to any agent, employee, or other representative of such entity that processes claims for such entity.

3. Among other things, the Code requires carriers to report:

- Quarterly to the Department on the timeliness of claims payments in the format set forth in Appendix A (claims payment exhibit report) of NJAC 11:22-1, and
- Quarterly and annually on late payments of claims and the reasons for any denials (claims prompt payment report) in the format set forth in Appendix B of NJAC 11:22-1.

4. Furthermore, the Code requires that the annual claims prompt payment report, which is due to be filed with the Department on or before March 31, pursuant to NJAC 11:22-1.9(a), be accompanied by the report of a private auditing firm, which may be a Certified Public Accountant (CPA) or a firm of CPAs. However, for calendar year 2001, the report of the private auditing firm may be filed with the Department on or before July 1, 2002. The Department has specified, in Bulletin No. 02-07, that the work shall be conducted, and the report shall be prepared, in accordance with agreed-upon procedures acceptable to the Department.

Applicability

5. This Statement of Position (SOP) was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address annual claims prompt payment reports as required by the New Jersey Administrative Code. Practitioners should note that the engagement described in this SOP is designed only to satisfy the requirements of the Code. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement.

The Code

Definitions

6. The following definitions are reprinted from the Code and are applicable when performing the agreed-upon procedures engagement described in this SOP.

Agent—Any entity, including a subsidiary of a carrier, or an organized delivery system as defined by N.J.S.A. 17:48H-1, with which a carrier has contracted to perform claims processing or claims payment services.

Carrier—An insurance company, health service corporation, hospital service corporation, medical service corporation or health maintenance organization authorized to issue health benefits plans in this State and a dental service corporation or dental plan organization authorized to issue dental plans in this State.

Claim—A request by a covered person, a participating health care provider, or a nonparticipating health care provider who has received an assignment of benefits from the covered person, for payment relating to health care services or supplies or dental services or supplies covered under a health benefits plan or dental plan issued by a carrier.

Clean claim—

1. The claim is for a service or supply covered by the health benefits plan or dental plan;
2. The claim is submitted with all the information requested by the carrier on the claim form or in other instructions distributed to the provider or covered person;
3. The person to whom the service or supply was provided was covered by the carrier's health benefits or dental plan on the date of service;
4. The carrier does not reasonably believe that the claim has been submitted fraudulently; and
5. The claim does not require special treatment. For the purposes of this subchapter, special treatment means that unusual claim processing is required to determine whether a service or supply is covered, such as claims involving experimental treatments or newly approved medications. The circumstances requiring special treatment should be documented in the claim file.

Covered person—A person on whose behalf a carrier offering the plan is obligated to pay benefits or provide services pursuant to the health benefits or dental plan.

Covered service or *supply*—A service or supply provided to a covered person under a health benefits or dental plan for which the carrier is obligated to pay benefits or provides services or supplies.

Dental plan—A benefits plan which pays dental expense benefits or provides dental services and supplies and is delivered or issued for delivery in this State by or through any carrier in this State.

Department—The Department of Banking and Insurance.

Health benefits plan—A benefits plan that pays hospital and medical expense benefits or provides hospital and medical services, and is delivered or issued for delivery in this State by or through a carrier. Health benefits plan includes, but is not limited to, Medicare supplement coverage and risk contracts to the extent not otherwise prohibited by Federal law. For the purposes of this chapter, health benefits plan shall not include the following plans, policies or contracts: accident only, credit, disability, long-term care, CHAMPUS supplement coverage, coverage arising out of a workers' compensation or similar law, automobile medical payment insurance, personal injury protection insurance issued pursuant to P.L. 1972, c.70 (N.J.S.A. 39:6A-1 et seq.) or hospital confinement indemnity coverage.

Health care provider or *provider*—An individual or entity which, acting within the scope of its license or certification, provides a covered service or supply as defined by the health benefits or dental plan. Health care provider includes, but is not limited to, a physician, dentist and other health care professional licensed pursuant to Title 45 of the Revised Statutes and a hospital and other health care facilities licensed pursuant to Title 26 of the Revised Statutes.

Reporting Requirements

7. The Code requires a carrier and its agent to remit payment of clean claims pursuant to specified time frames. The Code further requires that if a carrier or its agent denies or disputes a claim, in full or in part, the carrier or its agent must, within a specified time frame, notify both the covered person when he or she will have increased responsibility for payment, and the provider, of the basis for its decision to deny or dispute the claim.

8. The Code requires a carrier to report to the Department quarterly on the timeliness of claims payments in the format prescribed in NJAC 11:22-1, Appendix A, "New Jersey Claims Payment Exhibit." This quarterly report is not required to be subjected to an agreed-upon procedures engagement, nor is an annual claims payment exhibit report required to be filed with the Department.

9. The Code also requires a carrier to report to the Department on a quarterly and annual basis on the late payment of claims and the reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B, "Quarterly (Annual) Claims Prompt Payment Report." The Code requires that the annual claims prompt payment report be accompanied by a report of a private auditing firm, which may be a CPA or a firm of CPAs.

10. The Department has indicated, in Bulletin No. 02-07, that an agreed-upon procedures engagement pursuant to this SOP may be used to satisfy the requirement that an annual claims prompt payment report be accompanied by the report of a private auditing firm. Furthermore, in Bulletin No. 02-12, issued in May 2002, the Department has indicated that it agrees to the sufficiency of the procedures included in this SOP for its purposes.

Related Professional Standards

Chapter 2, "Agreed-Upon Procedures Engagements," of Statement on Standards for Attestation Engagements No. 10 (AT Sec. 201)

11. Agreed-upon procedures engagements performed to meet the requirements of the Code are to be performed in accordance with Chapter 2, "Agreed-Upon Procedures Engagements," of SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 201). As described in Chapter 2 of SSAE No. 10 (AT sec. 201.03), an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of Chapter 2 of SSAE No. 10 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of Chapter 2 of SSAE No. 10.

12. Chapter 2 of SSAE No. 10 (AT sec. 201.06) states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, ". . . (*c*) the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and (*d*) the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes."

13. As previously stated, Bulletin No. 02-07 from the Department states that an agreed-upon procedures engagement may be used to meet the requirement for an independent private auditing firm to report on the annual claims prompt payment reports as required by the New Jersey Administrative Code. Furthermore, the Department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the Code. Accordingly, practitioners should not eliminate any of the procedures presented in appendix B, "Agreed-Upon Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code," of this SOP or reduce the extent of the tests. The Department or the carrier may request that additional procedures be performed and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

Procedures to Be Performed

14. The agreed-upon procedures to be performed are applied to the carrier's annual claims prompt payment report, which reports on the late payment of claims and reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B.

15. The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B of this SOP. The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The findings for each procedure should be reported as *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular carrier, the procedure should be marked N/A rather than deleted from the report.

16. If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section "Description of Exceptions If Any." The practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner's report, the practitioner's explanation of the exception may include that information; for example, "Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management's assertion."

17. A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

18. Chapter 2 of SSAE No. 10 (AT sec. 201.40) states the following:

> The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertion related thereto) referred to in the practitioner's report, the practitioner should include this matter in his or her report. For example, if, during the course of applying agreed-upon procedures regarding an entity's internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedure, the practitioner should include this matter in his or her report.

19. A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B of this SOP. However, if information that contradicts the information in the carrier's annual claims prompt payment report comes to the practitioner's attention by other means, such information should be included in the practitioner's report. This also would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner's report but prior to the date of the practitioner's report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

Establishing an Understanding With the Client

20. In accordance with Chapter 2 of SSAE No. 10 (AT sec. 201.10), the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the Code. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written communication with the client (an engagement letter). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of NJAC 11:22-1
- A statement identifying the procedures to be performed as those set forth in SOP 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*
- A statement identifying the client and the Department as the specified parties to the agreed-upon procedures report
- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP and referring to Bulletin No. 02-12, which acknowledges the Department's responsibility for the sufficiency of the procedures in the SOP

- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the carrier's compliance with the requirements of NJAC 11:22-1, and that if an examination were performed, other matters might come to the practitioner's attention
- A statement indicating that the practitioner will not express an opinion or any other form of assurance
- A statement describing the client's responsibility to comply with the requirements of NJAC 11:22-1 and the client's responsibility for the information in the carrier's annual claims prompt payment report
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client and the Department
- A statement describing any arrangements to involve a specialist

Management Representations

21. Although Chapter 2 of SSAE No. 10 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, it is recommended that the practitioner obtain such a letter when performing the engagement described in this SOP. The representation letter generally should be signed by the appropriate members of management including the highest-ranking officer responsible for the carrier's compliance with the requirements of NJAC 11:22-1. Management's refusal to furnish written representations that the practitioner has determined to be appropriate for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement.

22. The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, the practitioner ordinarily would obtain the following representations from management:

- A statement acknowledging responsibility for compliance with the requirements of NJAC 11:22-1 and responsibility for the information in the carrier's annual claims prompt payment report
- A statement that there have been no errors or fraud that might indicate that the carrier is not in compliance with the requirements of

NJAC 11:22-1 and that there are no known matters (or that management has disclosed to the practitioner all known matters) that contradict the information in the carrier's annual claims prompt payment report

- A statement that management has disclosed to the practitioner any communications from regulatory agencies relating to the carrier's annual claims prompt payment report
- A statement that management has made available to the practitioner all information it believes is relevant to the carrier's annual claims prompt payment report
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require modification of the findings of the agreed-upon procedures

23. An illustrative representation letter is presented in appendix C, "Illustrative Management Representation Letter," of this SOP. For additional information regarding management's written representations in an agreed-upon procedures engagement, see Chapter 2 of SSAE No. 10 (AT sec. 201.37–.39).

Restriction on the Performance of Procedures

24. As previously stated, a practitioner should not agree to eliminate any of the procedures presented in appendix B of this SOP. If circumstances impose restrictions on the performance of the agreed-upon procedures, the practitioner should attempt to obtain agreement from the specified users for modification of the agreed-upon procedures presented in appendix B of this SOP. When such agreement cannot be obtained, the practitioner should describe the restriction(s) on the performance of procedures in his or her report or withdraw from the engagement.

Dating the Report

25. The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Effective Date

26. This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that report on annual claims prompt payment reports as required by the NJAC.

APPENDIX A

llustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in Chapter 2, "Agreed-Upon Procedures Engagements," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards,* vol. 1, AT sec. 201).

Independent Accountant's Report
on Applying Agreed-Upon Procedures

To the Management of ABC Carrier:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*, which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance (the Department), solely to assist you in complying with the reporting requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1.9 (NJAC 11:22-1.9) for Appendix B 20XX Annual Report (Exhibit I) for the year ended December 31, 20XX. Management of ABC Carrier is responsible for compliance with the requirements of NJAC 11:22-1. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of ABC Carrier and the Department. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached Appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached Appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on ABC Carrier's compliance with the requirements of NJAC 11:22-1 for the year ended December 31, 20XX. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the management of ABC Carrier and the State of New Jersey Department of Banking and Insurance, and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

APPENDIX B

Agreed-Upon Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

Procedures	*Findings* No Exception	*Findings* Exception	*Findings* N/A
The following procedures were applied to the ABC Carrier's 20XX Appendix B annual claims prompt payment report.			
We obtained supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, and for each of the five categories (physician, dental, other health care professional, hospital, or other health care facilities), where applicable, compared the number of claims and the amount of claims for each quarter and the annual period from the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report to the following columns of the report:			
• Total claims	______	______	______
• Denied ineligible	______	______	______
• Denied document	______	______	______
• Denied coding/enrollment	______	______	______
• Denied for amount	______	______	______
• Time limit special	______	______	______
• Time limit other	______	______	______
• Denied referred fraud	______	______	______
• Interest paid	______	______	______
• Interest amount paid	______	______	______
• Total paid	______	______	______

Procedures	*Findings* No Exception	Exception	N/A
We selected 10 percent of the claims from ABC Carrier's supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, with the selections distributed throughout the year. If 10 percent of the claims exceeded 50, then the number of items selected was limited to 50. If 10 percent of the claims resulted in less than 10 claims, then the number of items selected was 10, and for each item selected we:			
1. Compared the following information to ABC Carrier's claim payment system:			
• Paid amount	______	______	______
• Claim finalization or payment date	______	______	______
• Claim received date	______	______	______
• Denial code	______	______	______
• Claim category (physician, dental, other health care professional, hospital, or other health care facilities)	______	______	______
2. Compared the following information to the original claim information submissions:			
• Date received	______	______	______
• Amount billed	______	______	______
• Category (physician, dental, other health care professional, hospital, or other health care facilities)	______	______	______
3. Noted whether, per ABC Carrier's member records, original claim information submission, or both, the claim related to a policy issued in the state of New Jersey	______	______	______
4. If a selected claim was denied, compared denial reason indicated in ABC Carrier's claims system records to supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report	______	______	______

Procedures	*Findings*		
	No Exception	*Exception*	*N/A*
5. If a selected claim is a "clean claim," as defined in NJAC 11:22-1.2, and as determined by ABC Carrier, recalculated the amount of interest paid on the selected claim in accordance with the requirements of NJAC 11:22-1.5	______	______	______
We selected 10 claims from ABC Carrier's primary claims system, with the selections distributed throughout the year, and for each item selected, traced the selected claims covered under New Jersey contracts to the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report.	______	______	______
We proved the arithmetic accuracy of ABC Carrier's 20XX Appendix B annual claims prompt payment report.	______	______	______

Description of Exceptions if Any

____

____

____

____

____

APPENDIX C

Illustrative Management Representation Letter

[*ABC Carrier's Letterhead*]

[*Date*]

[*CPA Firm's Name and Address*]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code,* which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance, solely to assist us in complying with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1.9), for Appendix B 20XX Annual Report (Exhibit I) for the period from January 1, 20XX through December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for compliance with the requirements of NJAC 11:22-1 and for the information in ABC Carrier's annual claims prompt payment report.

2. During the year ended December 31, 20XX, there have been no errors or fraud that would indicate that ABC Carrier is not in compliance with the requirements of NJAC 11:22-1.

3. We have disclosed to you all known matters contradicting the information in ABC Carrier's annual claims prompt payment report.

4. There have been no communications from regulatory agencies relating to ABC Carrier's annual claims prompt payment report, including communications received between December 31, 20XX, and the date of this letter.

5. We have made available to you all information that we believe is relevant to ABC Carrier's annual claims prompt payment report.

6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX, and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[*Signature*]

[*Title*]

[*Signature*]

[*Title*]

Appendix Y

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines. Required modem speeds, expressed in bauds per second (bps), are listed for data lines.

Information Sources

Organization	General Information	Fax Services	Internet	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	*24 Hour Fax Hotline* (201) 938-3787	www.aicpa.org	*AcSEC Telephone Line* (212) 596-6008
Financial Accounting Standards Board	*Order Department* P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	*Action Alert Telephone Line* (203) 847-0700 (ext. 444)
National Association of Insurance Commissioners	*Order Department* 120 W. 12th St., Suite 1100 Kansas City, MO 64105-1925 (816) 471-7004	*Order by Fax* (816) 471-7004	www.naic.org	
U.S. General Accounting Office	*Superintendent of Documents* U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	*Information Line* (202) 512-2250	www.gpo.gov	
U.S. Securities and Exchange Commission	*Publications Unit* 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046	*Information Line* (202) 942-8090, ext. 3 (202) 942-8092 (tty)	www.sec.gov	

Appendix Z

Schedule of Changes Made to Audits of Property and Liability Insurance Companies

As of May 2002

Beginning May 2001, all schedules of changes reflect only current year activity to improve clarity.

Reference	Change
Paragraphs 1.04, 1.09, 1.28, 1.40, and 1.43	Revised to clarify guidance.
Paragraphs 1.54 and 1.57	Revised to reflect the issuance of SOP 01-5.
Paragraph 1.61	Revised to clarify guidance.
Paragraph 1.65	Revised to reflect the issuance of SOP 01-5.
Paragraph 1.66 and footnote 1	Added to reflect the issuance of SOP 01-5; Subsequent paragraphs renumbered.
Renumbered paragraph 1.68	Revised to reflect the issuance of SOP 01-5 and SOP 00-3; Footnotes * deleted.
Renumbered paragraph 1.71 (footnote **)	Redesignated as footnote *.
Renumbered paragraph 1.72 (Table 1.1)	Revised to reflect the issuance of FASB Statement No. 144; Footnote * added.
Renumbered paragraph 1.72 (Exhibit 1.1)	Revised to reflect the issuance of SOP 01-5; Footnote * replaced; Footnote ** added.
Paragraph 2.01 (footnotes * and **)	Added.
Paragraphs 2.02, 2.05, and 2.06	Revised to clarify guidance.
Paragraph 2.10	Revised to reflect the issuance of SAS No. 94 and divided into paragraphs 2.10 and 2.11; Subsequent paragraphs renumbered; Footnote * deleted.
Paragraph 2.11	Footnote 1 added to reflect the issuance of SAS No. 94; Subsequent footnotes renumbered.
Renumbered paragraphs 2.12 and 2.13	Revised to reflect the issuance of SAS No. 94. Renumbered paragraph 2.13 divided into paragraphs 2.13 and 2.17.
Paragraphs 2.14 (and footnote 2), 2.15, and 2.16	Added to reflect the issuance of SAS No. 94. Subsequent paragraphs and footnotes further renumbered.

Reference	Change
Renumbered paragraph 2.17	Footnote * added.
Renumbered paragraphs 2.18, 2.19, and 2.20	Revised to reflect the issuance of SAS No. 94; Footnote ** redesignated as footnote *.
Paragraphs 2.21, 2.22, 2.23, 2.24, 2.25, and footnotes 3, 4, 5, and *	Added to reflect the issuance of SAS No. 96; Subsequent paragraphs and footnotes further renumbered.
Renumbered paragraph 2.26	Revised to reflect the issuance of SAS No. 96.
Renumbered paragraphs 2.37 and 2.38	Revised to clarify guidance; Footnote * added.
Renumbered paragraph 2.41	Revised to clarify guidance; Footnote * added.
Paragraph 2.49	Added to reflect the issuance of SAS No. 96; Subsequent paragraphs further renumbered.
Renumbered paragraph 2.50	Revised to reflect the issuance of SAS No. 96.
Paragraph 3.01 (footnote *)	Redesignated as footnote 1.
Paragraphs 3.45, 3.46, and 3.47	Added to reflect the issuance of SOP 01-6.
Paragraph 4.01	Revised to reflect the issuance of SOP 01-5; Footnote * deleted.
Paragraph 4.06 (footnote *)	Redesignated as footnote 1.
Paragraphs 4.25 and 4.33	Revised to clarify guidance.
Paragraph 4.34 (footnote *)	Redesigated as footnote 2.
Paragraph 4.36 (footnote *)	Added.
Paragraph 4.49, table 2 (footnotes *, †, and ‡)	Redesigated as footnotes 3, 4, and 5.
Paragraph 4.54, tables 3, 5, and 6 (footnotes * and †)	Redesigated as footnotes 6, 7, 8, 9, and 10, respectively.
Paragraphs 4.65 and 4.70	Revised to clarify guidance.
Paragraphs 4.83, 4.100, and 4.101 (footnotes *)	Added.
Paragraph 4.114	Revised to reflect the issuance of SOP 01-5; Footnote * deleted.
Paragraph 4.115	Revised to reflect the issuance of SOP 01-5 and divided into paragraphs 4.115 and 4.116; Subsequent paragraphs renumbered.

Reference	Change
Renumbered paragraph 4.117	Revised to reflect the issuance of SOP 01-5.
Renumbered paragraph 4.120	Revised to clarify guidance.
Renumbered paragraphs 4.121, 4.122, and 4.124	Revised (and footnote 11 added) to reflect the issuance of SOP 01-5.
Renumbered paragraph 4.125	Revised to clarify guidance.
Renumbered paragraph 4.127	Revised to reflect the issuance of SOP 01-5.
Renumbered paragraphs 4.128 and 4.129	Revised to clarify guidance.
Paragraph 5.08	Revised to clarify guidance. Footnote * deleted.
Paragraphs 5.09, 5.11, 5.12, and 5.13 (footnotes *, **, and ***)	Deleted.
Paragraph 5.23	Revised to clarify guidance.
Paragraph 5.24	Revised (and footnotes 2 and 3 added) to clarify guidance; footnote * revised and redesignated as footnote 1.
Paragraph 5.35	Revised to clarify guidance; Footnote * deleted.
Paragraphs 5.39, 5.40, 5.41, 5.42, 5.43, 5.44, and 5.45 (footnotes *, **, ***, and +)	Deleted.
Paragraph 5.46	Revised to reflect the issuance of Derivative Implementation Group guidance.
Paragraph 5.47	Revised to clarify guidance.
Paragraph 5.49 (footnote *)	Added.
Paragraph 5.52	Revised to clarify guidance; Footnote * added.
Paragraphs 5.53 and 5.55 (footnotes *)	Added.
Paragraph 5.60	Added to reflect statutory guidance; Subsequent paragraphs renumbered.
Renumbered paragraphs 5.62 and 5.63 (footnote * and **)	Added.
Renumbered paragraph 5.64	Revised to clarify guidance; Footnote * deleted; Footnotes *** and * added.
Renumbered paragraph 5.65	Revised to reflect statutory guidance; Footnote * replaced.

Reference	Change
Paragraph 6.37	Revised to clarify guidance.
Paragraph 6.45	Revised to reflect the issuance of SAS No. 94.
Paragraph 6.47 (footnote *)	Added.
Paragraph 6.54	Revised, Footnote * added.
Paragraph 6.69	Revised to clarify guidance.
Paragraph 6.81 (Exhibit 6.1)	Revised (and footnote 7 added) to clarify guidance; Footnote * added.
Paragraph 7.02	Added to reflect the issuance of tax laws; Subsequent paragraphs renumbered.
Renumbered paragraph 7.20 (footnote 1)	Added to clarify statutory guidance.
Renumbered paragraphs 7.38, 7.54, and 7.61	Revised to clarify guidance.
Paragraph 8.01	Revised to reflect the issuance of SOP 01-5; Footnote * deleted.
Paragraph 8.04	Revised to clarify guidance.
Paragraph 8.19	Revised.
Paragraphs 8.22 and 8.23	Revised to reflect the issuance of SOP 01-5.
Paragraph 8.24	Revised to clarify guidance.
Paragraphs 8.25, 8.27, 8.28, and 8.29	Revised to reflect the issuance of SOP 01-5. Footnote 1 revised to clarify guidance.
Paragraph 8.30	Revised to clarify guidance.
Paragraph 8.31	Revised to reflect the issuance of SOP 01-5.
Appendix A	Revised to reflect the issuance of SAS No. 96 and new fraud guidance.
Appendix B	Revised to clarify guidance.
Appendix C	Revised to reflect the issuance of SOP 01-5 and SOP 01-6.
Appendix E	Revised to reflect statutory guidance.
Appendix G	Revised to clarify guidance.
Appendix K	Revised to reflect the issuance of FASB Statement No. 144 and the forthcoming combined guide for lending and depository institutions.
Appendix Q	Revised to reflect the issuance of FASB Statement No. 140.
Appendix U	SOP 00-3 added; Subsequent appendixes relettered.
Appendix V	SOP 01-3 added; Subsequent appendixes further relettered.
Appendix W	SOP 01-5 added; Subsequent appendixes further relettered.
Appendix X	SOP 02-1 added; Subsequent appendixes further relettered.

Glossary

Abstract. A form containing basic data shown on a policy. Copies of an abstract may be used by the accounting, statistical, payroll audit, and inspection departments.

Accident year. The year in which an accident occurred.

Account current or agents' account. See *Agency billing.*

Accretion of discount on bonds. Adjustment of the purchase price of bonds purchased at less than par value to increase the value to par at maturity date. The adjustment is calculated to yield the effective rate of interest at which the purchase was made, which is called the *interest method.*

Acquisition costs. Costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred are considered to be acquisition costs.

Additional premium. A premium due from an insured arising from an endorsement.

Adjustment bureau. An organization formed by a group of insurance companies to investigate, adjust, and negotiate claims on behalf of the companies.

Admitted asset. An asset recognized and accepted by state insurance regulatory authorities in determining the financial condition of an insurance company.

Agency billing. Any of various methods of premium billing and collection in which the insured is billed by the agent and the premium is collected by either the agent or the insurance company.

Agency company. An insurance company whose business is produced through a network of agents, as distinguished from a direct writing company whose business is produced by company employees.

Agency reinsurance. Reinsurance arranged to be assumed or ceded for an insurer by one of its agents who usually handles the details of writing the policies and collecting or paying the premiums. For example, on very large risks the agent frequently issues only one policy to the insured and then obtains reinsurance from other companies to reduce the exposure of the insurer to a desired level.

Agency system. A system of producing business through a network of agents. Such agents have a contract to represent the company and are of three classes: local, regional, and general. These classes are compensated at differing rates of commission, and general agents have much greater responsibilities and duties than local and regional agents.

Agent. An independent contractor who represents one insurance company, called an *exclusive agent,* or more than one company, called an *independent agent*, with express authority to act for the company or companies in dealing with insureds.

Agents' balance. Premium balances, less commissions payable thereon, due from agents and brokers.

Aggregate excess of loss. A stop-loss agreement designed to prevent a ceding company's loss from exceeding a predetermined limit. For example, if under an agreement indemnifying a company against losses in excess of a 70-percent loss ratio, the ceding company's loss ratio exceeds 70 percent, then recovery will be made from the reinsurer of the amount necessary to reduce the loss ratio to 70 percent.

Alien company. Insurance company domiciled in a foreign country.

Amortization of premiums on bonds. Adjustment of the purchase price of bonds purchased at more than par value to decrease the value to par at maturity. The adjustment is calculated to yield the effective rate of interest at which the purchase was made, known as the *interest method.*

Annual pro rata. A basis used to calculate unearned premiums involving the assumption that the average date of issue of all policies written during the year is the middle of the year.

Annual statement (convention statement or convention form). A statement furnishing the complete information regarding the company's condition and affairs at December 31 of each year required by insurance departments of the various states in which a company is authorized to transact business. This annual statement must be filed on the form prescribed by the NAIC with the various insurance departments by March 1 of the following year.

Annuity contract. Contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life.

Application. A request for insurance submitted to the insurer by or on behalf of the insured. An application usually includes sufficient information for the insurer to determine whether it wishes to accept the risk. In some lines of insurance the terms *daily* and *application* are used synonymously.

Assessment enterprise. An insurance company that sells insurance to groups with similar interests, such as church denominations or professional groups. Some assessment enterprises also sell insurance directly to the general public. If the enterprise cannot pay all claims, the members may be assessed.

Assets, ledger. Assets that are recorded in a company's general ledger. They usually include investments, cash, agents' balances, or uncollected premiums and reinsurance recoverable.

Assets, nonadmitted. Assets, or portions thereof, that are not permitted to be reported as admitted assets in the annual statement filed with various insurance departments. Nonadmitted assets are defined by the insurance laws of various states. Major nonadmitted assets include: an excess of book value over statement value of investments, agents' balances or uncollected premiums over three months due, and furniture, fixtures, supplies, equipment, and automobiles.

Assets, nonledger. Assets not recorded on a company's general ledger. They usually include an excess of statement value of stocks and bonds over their book values and accrued interest or other accrued income on investments.

Associations, pools, and syndicates. Organizations formed by several insurance companies or groups of companies as joint ventures to underwrite specialized types of insurance or to write insurance in specialized areas.

Assuming company. A company that accepts all or part of an insurance risk from another company through reinsurance.

Audit premiums. Earned premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. Such audits are made and such reports are submitted either monthly, quarterly, semiannually, or annually.

Automatic treaty. Reinsurance treaty usually pro rata, under which the reinsurer is committed to accept from the ceding company a fixed share of each risk or of specified risks. The ceding company is obligated to cede, and the reinsurer is obligated to accept.

Average reserves. A method of estimating loss liabilities by multiplying the number of outstanding claims by an average amount per claim based on past experience.

Binder. An agreement, which may be written or oral, whereby one party agrees to insure another pending receipt of and final action on the application.

Bordereau. A detailed listing of premiums or loss transactions, or both, usually prepared monthly and given to interested parties. Frequently rendered by ceding companies to reinsurers and by large general agents to companies.

Brokers. Licensed representatives who place the insurance of their clients with insurance companies. Compensation for their services consists of commissions paid to them by the insurance companies. They are not agents of the companies, and the commissions they receive are usually lower than that of agents who legally represent the companies.

Bulk reinsurance. See *Portfolio reinsurance*.

Cancellation. Complete termination of an existing policy before expiration.

Case basis. Liabilities for losses (claims) or loss expenses determined based on individual estimates of the value of each unpaid loss (claim).

Case reserve. A liability for loss estimated to be paid in the future on an outstanding claim.

Catastrophe. A conflagration, earthquake, windstorm, explosion, or similar event resulting in substantial losses. Catastrophe losses—the whole loss insured by an insurance company from a single catastrophic event—are usually reinsured under excess-of-loss treaties in order to limit any one such loss to a specific dollar amount.

Ceding company. A company that transfers all or part of an insurance risk to another company through reinsurance. Also called a *primary company*.

Cession. A unit of insurance passed on to a reinsurer by a ceding or primary company. Under certain kinds of reinsurance treaties, many reinsurers give each transaction a number, called a *cession number*.

Claim. A demand for payment of a policy benefit because of the occurrence of an insured event, such as the death or disability of the insured, the maturity of an endowment, the incurrence of hospital or medical bills, the destruction or damage of property, and related deaths or injuries; defects in, liens on, or challenges to the title to real estate, or the occurrence of a surety loss.

Claim adjusting. The process of investigating, appraising, negotiating and, sometimes, settling claims.

Claim frequency. The relative incidence of claims in relation to an exposure base.

Claim severity. The relative magnitude of the dollar amount of claims.

Claim or loss files. All data relating to each loss or claim together in a folder or stapled together, or the like, and referred to as the loss or claim file.

Class or manual rating. A method of determining premiums based on standard rates for large groups of similar risks.

Combined ratios. The sum of both the loss ratio and expense ratio used to measure underwriting performance.

Commissions. Compensation paid by an insurance company to agents or brokers for placing insurance coverage with the company, usually determined as percentages of the premiums.

Contribution to premium in force. Net change in premiums in force for a period or net original premiums written during a period (total original premiums less original return premiums).

Convention statement or convention form. See *Annual statement.*

Cost recovery method. A method of accounting for insurance coverage provided by the reporting entity in which premiums are recognized as revenue in amounts equal to estimated claim costs when insured events occur until the ultimate premium is reasonably estimable and recognition of income is postponed until that time.

Daily report or daily. A copy of a policy retained by an insurance company or forwarded to the company by an agent. The daily includes all special provisions and endorsements, and it is one of the basic documents in an insurance office.

Declaration sets. Documents generated by an insurance company in processing policy applications and endorsements that include billing statements and insurance ID card, as well as information such as terms of the policies, lines of coverage, premiums, and agent information.

Deposit method. A method of recognizing premium revenue and claim costs when the ultimate premium is reasonably estimable.

Deposit premiums. Provisional premium payments by policyholders that are adjusted at the end of the policy terms based on actual coverage provided.

Development (runoff) of loss reserves. Comparison of the loss reserves outstanding at a particular date with the total of the payments on such losses from the reserve date to the development date, plus the estimated losses still unpaid at the date of the development.

Differences. Term applied to the differences between accounts current rendered by agents and transactions shown on the company's records, caused, for example, by the agents and the company using different cutoff dates or by errors and omissions by the company or the agents.

Direct billing. Billing by an insurance company directly to insureds for premiums due. On collection, the company pays the commission to the agent.

Direct premiums. Total premiums, net of return premiums, on policies issued to provide the primary insurance on a given risk.

Direct writing company. An insurance company whose business is produced by company employees, as distinguished from an agency company whose business is produced by agents.

Discounting. Recording future claim payments and expenses at their present value.

Domestic insurers. Insurance companies domiciled in a particular state.

Earned premiums. Pro rata portions of premiums applicable to the expired period of a policy.

Effective date. The date when insurance coverage under a policy begins.

Endorsement. Documentary evidence of a change in an existing policy that may result in a change in premium, return premium, or no premium adjustment.

Excess insurance. A policy covering the insured against loss in excess of a stated amount. The underlying amount is usually insured by another policy but can be retained by the insured.

Excess-of-loss treaty. A kind of reinsurance contract in which the reinsurer pays all or a specified percentage of a loss caused by a particular occurrence or event (frequently of a more or less catastrophic nature) in excess of a fixed amount and up to a stipulated limit. Most such contracts do not apply to specific policies but to aggregate losses incurred under all policies subject to the particular hazards reinsured. The premium is usually a percentage of the net premiums written by the carrier for the hazards subject to such reinsurance.

Excess schedule preserves. The excess of minimum reserves required by state regulatory authorities over the estimated liability for losses established for certain lines, primarily bodily injury liability and workers' compensation. Also called *Statutory loss reserves*.

Expense ratio. Underwriting expenses divided by written premiums.

Experience rating. Prospective adjustment of premiums based on the insured's past experience under the coverage.

Exposure. Measurement of the extent of a hazard assumed by the carrier. From the statistical standpoint of rate making, exposure is the product of the amount of insurance at risk and the policy period expressed in years.

Face sheet. A sheet affixed to the front of a claim file containing abstracts of coverage and loss notices along with other information for later use in developing statistics for reserve analysis and product pricing.

Facultative reinsurance. Arrangements under which each risk to be reinsured is offered to and accepted or rejected by the reinsurer. Such arrangements do not obligate the ceding company to cede or the reinsurer to accept.

Fair access to insurance requirements (FAIR) plan. A federally approved and state supervised program to make property insurance available in high-risk areas.

Fidelity bond. Insurance that covers employers against dishonest acts by employees.

Fire and allied lines insurance. Property insurance coverage for risks such as fire, windstorm, hail, and water damage.

Foreign insurers. Insurance companies domiciled outside a particular state.

Fronting. An arrangement in which an issuer issues a policy on a risk for and at the request of another insurer with the intent of reinsuring the entire risk with the other insurer.

Funds held by a company under reinsurance treaty. An account used to record a liability from a deposit from a reinsurer or the withholding of a portion of the premiums due as a guarantee that a reinsurer will meet its loss and other obligations.

Funds held by or deposited with ceding reinsurers. An asset account used by a reinsurer to record deposits made with ceding companies, pools, or associations of portions of premiums due from them to guarantee that the reinsurer will meet its loss and other obligations.

General agents. Agents assigned exclusive territories in which to produce business on behalf of an insurance company.

General liability insurance. Liability coverage for most physical and property damages not covered by workers' compensation or automobile liability insurance.

Gross in force. Aggregate premiums from all policies on direct and assumed business recorded before a specified date that have not yet expired or been canceled.

Gross net premium income. As used in reinsurance contracts, gross written premiums, less return premiums and reinsurance premiums. This term has the same meaning as *net written premiums* or *net premiums* in the United States. In Europe, the term *net premiums* refers to gross premiums received less return premiums, reinsurance premiums, and commissions paid on premiums.

Gross premium. The premium charged to a policyholder for an insurance contract. See also *Net premiums.*

Group insurance. Insurance protecting a group of persons, usually employees of an entity and their dependents. A single insurance contract is issued to their employer or other representative of the group. Individual certificates often are given to each insured individual or family unit. The insurance usually has an annual renewable contract period, although the insurer may guarantee premium rates for two or three years. Adjustments to premiums relating to the actual experience of the group of insured persons are common.

Hazard. The risk or peril or source of risk insured against. This term is frequently used interchangeably with the terms *risk* and *peril.*

Incurred-but-not-reported (IBNR) claims. Claims relating to insured events that have occurred but have not yet been reported to the insurer or reinsurer as of the date of the financial statements.

Incurred loss ratio. Ratio calculated by dividing incurred losses by earned premiums.

Incurred losses (claims). Losses paid or unpaid for which the company has become liable during a period. Incurred losses for a period are calculated by adding unpaid losses at the end of the period to losses paid during the period and subtracting unpaid losses at the beginning of the period.

Individual or judgment rating. A method of determining premiums for large or unusual risks based on an evaluation of the individual risk.

In-force premiums. Aggregate premiums from all policies recorded before the specified date that have not expired or been canceled.

Inland marine insurance. Insurance coverage of property capable of being transported (other than transocean).

Installment premiums. Premiums payable periodically rather than in a lump sum at the inception or effective date of the policy.

Insurable value. The stated value in an insurance contract. It may be the cash or market value, the declared value, or the replacement value.

Insurance expense exhibit. A supplement to the annual statement to be filed with each Insurance Department usually by May 1, rather than on March 1, the day on which the annual statement is due to be filed. The net gain or loss from underwriting for each line of business written by the company during the year reported on is shown on this exhibit.

Insurance Regulatory Information System (IRIS). A system of eleven tests based on studies of financially troubled companies compared to financially sound companies. Usual ranges are established under each of the tests. The system is intended to assist in identifying companies requiring close surveillance (formerly called *Early Warning System*).

Insured. The person whose life, property, or exposure to liability is insured.

Interinsurance exchange or reciprocal. An unincorporated aggregation of individuals or firms called *subscribers* who exchange insurance through an attorney-in-fact. Each subscriber is therefore both an insurer and an insured.

Intermediary. A reinsurance broker who negotiates reinsurance contracts on behalf of the reinsured (ceding company) with the reinsurer.

Investment expenses. According to the uniform expense regulation, all expenses incurred wholly or partially in connection with the investing of funds and the obtaining of investment income.

Judgment rating. See *Individual or judgment rating*.

Liabilities, ledger. Liabilities recorded in a company's general ledger.

Liabilities, nonledger. Liabilities not recorded in a company's general ledger but available from other basic records or sources.

Liability for (claim) adjustment expenses. The amount needed to provide for the estimated ultimate cost required to investigate and settle losses relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date), whether or not reported to the insurer at that date.

Liability for unpaid claims. The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date). The estimated liability includes the amount of money that will be required for future payments on both (1) claims that have been reported to the insurer and (2) claims relating to insured events that have occurred but have not been reported to the insurer as of the date the liability is estimated.

Line. Kind of insurance. In relation to the amount an insurance company accepts on a risk: (1) the limit a company has fixed for itself as maximum exposure on a class of risk and (2) the actual amount the company has in fact accepted on a single risk.

Long-duration contract. An insurance contract that generally is not subject to unilateral changes in its provisions, such as a noncancelable or guaranteed renewable contract, and requires the performance of various functions and services (including insurance protection) for an extended period.

Loss (claim)-adjustment expenses. Expenses incurred in the course of investigating and settling claims. Loss-adjustment expenses include any legal and adjusters' fees and the costs of paying claims and all related expenses.

Loss ratios. Expression in terms of ratios of the relationship of losses to premiums. Two ratios in common usage are (1) paid loss ratio—paid losses divided by written premiums or earned premiums, and (2) incurred loss ratio—incurred losses divided by earned premiums.

Loss reserves. A term used in statutory accounting for the liability for unpaid losses.

Losses. Claims.

Losses, reported. Losses resulting from accidents or occurrences that have taken place and on which the company has received notices or reports of loss.

Maintenance costs. Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

Manual rating. See *Class or manual rating.*

Market conduct examination. A review of an insurance company's sales, advertising, underwriting, risk-rating, and claims practices that may affect policyholders or claimants. It may be performed by or on behalf of regulatory authorities.

Merit rating. Any of various methods of determining premiums by which standard rates are adjusted for evaluation of individual risks or for the insureds' past or current experience.

Monthly pro rata. A basis used for calculation of unearned premiums involving the assumption that the average date of issue of all policies written during any month is the middle of that month.

Morbidity. The relative incidence of disability because of disease or physical impairment.

Mortgage guaranty insurance enterprise. An insurance enterprise that issues insurance contracts that guarantee lenders, such as savings and loan associations, against nonpayment by mortgagors.

Mutual company. Cooperative nonprofit association of persons whose purpose is to insure themselves against various risks.

NAIC (National Association of Insurance Commissioners). An association of the Insurance Commissioners of various states in the United States.

Net premiums for long-duration insurance contracts. The portion of the gross premium required to provide for all benefits and expenses.

Net premiums for short-duration contracts. Premiums written or received on direct and assumed business, less return premiums and less reinsurance ceded premiums.

Ocean marine insurance. Coverage for (1) a ship and its equipment, (2) the cargo, (3) the freight paid for use of the ship, and (4) liability to third parties for damages.

Original premium. The premium for the full term of a policy. In case the policy has been changed, the original premium can be determined by multiplying the amount currently insured by the latest premium rate shown on the policy or an endorsement of the policy.

Paid losses. Disbursements for losses during the period.

Participating company. An insurance company that participates in an insurance pool, association, or syndicate.

Participating insurance. Insurance in which the policyholder is entitled to participate in the earnings or surplus of the insurance enterprise. The participation occurs through the distribution of dividends to policyholders.

Peril. Classification of loss occurrences insured against, such as fire, windstorm, collision, hail, bodily injury, property damage, or loss of profits.

Personal lines. Kinds of insurance policies issued to individuals.

Policyholder dividends. Payments made or credits extended to the insured by the company, usually at the end of a policy year, that result in reducing the net insurance cost to the policyholder. Such dividends may be paid in cash to the insureds or applied by the insureds as reductions of the premiums due for the next policy year.

Policy year. The year during which a policy is effective.

Pooling. Practice of sharing all business of an affiliated group of insurance companies among the members of the group.

Portfolio reinsurance. Reinsurance on a bulk basis. Occurs frequently at the inception or termination of a reinsurance treaty. Also used as a means by which a company may retire from a particular agency or territory or from the insurance business entirely.

Premium. The consideration paid for an insurance contract.

Premium deficiency. For short-duration contracts, the amount by which anticipated losses, loss-adjustment expenses, policyholder dividends, unamortized acquisition costs, and maintenance expenses exceed related revenues.

Premium register. Listing of policies issued, generally in policy-number order. Normally computer generated.

Premium taxes. Taxes levied at varying rates on insurance companies by the various states on premiums written.

Premiums written. The premiums on all policies a company has issued in a period of time, as opposed to *Earned premiums*.

Proof of loss. A sworn statement furnished by an insured to the carrier setting forth the amount of loss claimed. This form, which is usually used in the settlement of first-party losses, includes the date and description of the occurrence, amount of loss claimed, interested insurers, and so on.

Property and liability insurance enterprise. An enterprise that issues insurance contracts providing protection against (1) damage to, or loss of, property caused by various perils, such as fire and theft, or (2) legal liability resulting from injuries to other persons or damage to their property. Property and liability insurance enterprises also can issue accident and health insurance contracts. The term *property and liability insurance enterprise* is the current terminology used to describe a fire and casualty insurance enterprise. Property and liability insurance enterprises may be either stock or mutual organizations.

Pro rata reinsurance. The reinsured and the reinsurer participate in the premiums and losses on every risk that comes within the scope of the agreement in fixed proportion.

Quota-share reinsurance. A form of pro rata reinsurance. A reinsurance of a certain percentage of all the business or certain classes of or parts of the business of the reinsured. For example, a company may reinsure under a quota-share treaty 50 percent of all of its business or 50 percent of its automobile business.

Rating bureau. An organization supervised by state regulatory authorities that assists member companies in obtaining approval for premium rates.

Reciprocal or interinsurance exchanges. A group of persons, firms, or corporations (commonly referred to as *subscribers*) that exchange insurance contracts through an attorney-in-fact (an attorney authorized by a person to act in that person's behalf).

Reinsurance. A transaction in which a reinsurer (*assuming enterprise*), for a consideration (*premium*), assumes all or part of a risk undertaken originally by another insurer (*ceding enterprise*). However, the legal rights of the insured are not affected by the reinsurance transaction, and the insurance enterprise issuing the insurance contract remains liable to the insured for payment of policy benefits.

Reinsurance assumed premiums. All premiums (less return premiums) arising from policies issued to assume a liability, in whole or in part, of another insurance company that is already covering the risk with a policy.

Reinsurance, authorized. Reinsurance placed with companies authorized to transact business in the state of filing.

Reinsurance, unauthorized. Reinsurance placed with companies not authorized to transact business in the state of filing.

Reinsurance ceded premiums. All premiums (less return premiums) arising from policies or coverage purchased from another insurance company for the purpose of transferring a liability, in whole or in part, assumed from direct or reinsurance assumed policies.

Reinsurance in force. Aggregate premiums on all reinsurance ceded business recorded before a specified date that have not yet expired or been canceled.

Reinsurance intermediaries. Brokers, agents, managing general agents, and similar entities that bring together reinsurance purchasers and sellers.

Reported claims. Claims relating to insured events that have occurred and have been reported to the insurer and reinsurer as of the date of the financial statements, as opposed to incurred-but-not-reported (IBNR) claims.

Reporting form contract. Insurance contract for which the premium is adjusted after the contract term based on the value of the insured property.

Retention. The net amount of any risk a company does not reinsure but keeps for its own account.

Retroactive commissions. Commissions paid to agents or brokers for which the final amount is determined based on the insured's loss experience.

Retrocession. A reinsurance of reinsurance assumed. For example, B accepts reinsurance from A, and B in turn reinsures with C the whole or a part of the reinsurance B assumed from A. The reinsurance ceded to C by B is called a *retrocession*.

Retrospective experience rating. A method of determining final premium in which the initial premium is adjusted during the period of coverage based on actual experience during that same period.

Retrospective premium. Premium determined after expiration of the policy based on the loss experience under the policy. The initial premium charged on such policies is referred to as the standard premium.

Return premiums. A premium refund due the insured from an endorsement or cancellation.

Risk. See *Hazard.*

Risk of adverse deviation. A concept used by life insurance enterprises in estimating the liability for future policy benefits relating to long-duration contracts. The risk of adverse deviation allows for possible unfavorable deviations from assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses. The concept is referred to as *risk load* when used by property and liability insurance enterprises.

Runoff data. See *Development (runoff) of loss reserves.*

Salvage. The amount received by an insurer from the sale of property (usually damaged) on which the insurer has paid a total claim to the insured and has obtained title to the property.

Schedule rating. A method of determining the premium by which a standard rate is adjusted based on an evaluation of the relative exposure to risk.

Short-duration contract. A contract that provides insurance protection for a fixed period of short duration and enables the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

Spread-loss treaty. A contract on an excess-of-loss basis designed to pay certain losses over a given or stipulated amount and to average such losses over a period of years. Five years is the usual period, with the premium adjustable within fixed minimum and maximum limits according to the company's experience. Such a contract protects the ceding company against shock losses and spreads those costs over the given period, subject to the maximum and minimum premium each year.

Statutory accounting practices. Accounting principles required by statute, regulation, or rule, or permitted by specific approval that an insurance enterprise is required to follow in preparing its annual statement for submission to state insurance departments.

Statutory loss reserves. The amount by which reserves required by law on bodily injury and workers' compensation losses exceeds the case-basis loss and loss-expense reserves carried by a company for such losses.

Stock companies. Corporations organized for profit to offer insurance against various risks.

Stop-loss reinsurance. Kind of excess reinsurance also called excess-of-loss ratio. Provides that the insurer will suffer the loss in its entirety until the total amount of the loss is such that the loss ratio (losses divided by, premiums) exceeds an agreed loss ratio, after which the reinsurer reimburses the insurer the amount needed to bring the loss ratio down to the agreed percentage.

Subrogation. The right of an insurer to pursue any course of recovery of damages, in its name or in the name of the policyholder, against a third party who is liable for costs relating to an insured event that have been paid by the insurer.

Surety bond. Insurance coverage that provides compensation to a third party for the insured's not performing specified acts within a stated period.

Surplus lines. Risks not fitting normal underwriting patterns, involving a degree of risk that is not commensurate with standard rates or that will not be written by standard carriers because of general market conditions.

Policies are bound or accepted by carriers not licensed in the jurisdiction where the risk is located, and generally are not subject to regulations governing premium rates or policy language.

Surplus share reinsurance. Reinsurance on a pro rata basis of only those risks on which coverage exceeds a stated amount.

Surplus treaty reinsurance. A treaty on a pro rata basis reinsuring surplus liability on various risks. The reinsurer shares the gross lines of the ceding company. The amount reinsured varies according to different classes of risks and the net retention that the ceding company wishes to retain for its own account. Ceding companies frequently have several layers of surplus treaties so that they may accommodate very large risks; usually, the reinsurer's participation in any one surplus treaty is limited to a certain multiple of the ceding company's retention. Premiums and losses are shared by the reinsurer and the ceding company on a pro rata basis in proportion to the amount of risk insured or reinsured by each. This is one of the oldest forms of treaty reinsurance and is still in common use in fire reinsurance.

Syndicates. See *Associations, pools, and syndicates.*

Title insurance enterprise. An enterprise that issues title insurance contracts to real estate owners, purchasers, and mortgage lenders, indemnifying them against loss or damage caused by defects in, liens on, or challenges to their titles on real estate.

Treaty. A contract of reinsurance.

Treaty-basis reinsurance. The automatic reinsurance of any agreed-on portion of business written as specified in the reinsurance contract.

Ultimate-developed-cost method. A method of estimating loss reserves based on a statistical average of the ultimate cost of all claims in a particular line.

Underwriting. The process by which an insurance company determines whether and for what premium it will accept an application for insurance.

Unearned premiums. The pro rata portion of the premiums in force applicable to the unexpired period of the policy term.

Workers' compensation insurance. Coverage that provides compensation for injuries sustained by employees in their employment.

Zone examination. An examination of an insurance company undertaken by on or behalf of regulatory authorities in a group of states.

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Rating Organizations

A.M. Best Company publishes two reference guides that are useful in determining an insurer's financial position. *Best's Insurance Reports: Property and Liability* is a comprehensive analysis of virtually all property and liability insurers. *Best's Key Rating Guide: Property and Liability* is a smaller and less comprehensive book, but also includes useful information.

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Additional Property and Liability Insurance Company Publications

Insurance Companies Audit Risk Alert (ARA)

Find out about current economic, regulatory and professional developments before you perform your audit engagement. This ARA will make your audit planning process more efficient by giving you concise, relevant information that shows you how current developments may impact your clients and your audits.

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Having been updated to reflect recent AICPA and FASB pronouncements, this aid becomes an invaluable tool to both preparers and auditors of employee benefit plan financial statements.

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